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The Liability of Controlling Persons Under the Federal Securities Acts

Loftus C. Carson II

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ARTICLES

THE LIABILITY OF CONTROLLING PERSONS UNDER THE FEDERAL SECURITIES ACTS

*Loftus C. Carson, II**

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I. INTRODUCTION

In the course of adopting the Securities Act of 1933¹ (the Securities Act) and the Securities Exchange Act of 1934² (the Exchange Act) (together the Securities Acts) Congress determined that, to be effective, a scheme of federal securities regulation should encompass the conduct of persons with control of direct perpetrators of securities fraud.³ Consequently, Congress included provisions in the Securities Act (section 15)⁴ and the Exchange Act (section 20(a))⁵ that provide for the potential liability of persons based on their control relationship with primary violators of those Acts. Under these provisions, controlling persons are liable to the same extent as their controlled persons, unless the controlling persons can establish the defenses provided for under the measures.⁶ Despite the controlling persons provi-

1 Ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

2 Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (1994)).

3 See *infra* notes 20-35 and accompanying text.

4 Section 15 of the Securities Act provides that:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [section 11 or section 12], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1994). Note that in this Article I refer to sections of the Securities Acts by their original, widely recognized section numbers. However, I will cite them to their current U.S.C. section.

5 Section 20(a) of the Exchange Act provides that:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1994).

6 See generally Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983); William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313 (1988); Note, "Controlling" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts, 72 MINN. L. REV. 930 (1988).

sions' potential as enforcement tools and sources of compensation for victims of Securities Acts violations, a great deal of uncertainty surrounds the scope and proper application of the measures more than sixty years after their enactment. I will address that uncertainty herein.

Congress employed broad language in sections 15 and 20(a) to allow federal courts the flexibility to interpret the provisions in light of evolving practices in securities transactions.⁷ The courts' task has been made more daunting by the provisions' sparse legislative history.⁸ Given the sweep of the provisions' language and the minimal legislative history concerning them, it perhaps is not surprising that uniform approaches to the resolution of certain central questions about controlling person liability under the Securities Acts have not emerged. Though broad, the language employed in sections 15 and 20(a) does support the consensus that liability under both provisions turns on the presence of (i) the primary Securities Acts liability of the putative controlled person, (ii) control by the defendant over the primary Securities Acts violator, and (iii) the failure of the defendant controlling person to establish the statutory defenses contained in the provisions.⁹ Significantly, however, the federal courts have not been in agreement about the following issues: 1) how to determine when a person is a controlling person within the meaning of sections 15 and 20(a);¹⁰ or 2) how a controlling person, to avoid liability, can satisfy the requirements of the defenses provided for in the sections.¹¹ Be-

7 See, e.g., *infra* note 54 and accompanying text.

8 For example, the only direct legislative history concerning the controlling persons provisions (that appearing in a legislative report) is found in a single paragraph. See *infra* note 67 and accompanying text.

9 See generally Ferrara & Sanger, *supra* note 6, at 1007-22.

10 For example, some courts have held that a person may be presumed to be a controlling person based on the person's position or status, say as a corporate officer or director, if it necessarily conveys upon its holder the potential for control. See, e.g., *Harriman v. E.I. DuPont de Nemours & Co.*, 372 F. Supp. 101, 105 (D. Del. 1974) (holding that "status" may suffice to render one a controlling person if the status is such that it involves potential for control). Other courts have rejected an approach that allows a controlling person determination to be made based on the occupation of a position or status that is potentially a controlling one. See, e.g., *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509-10 (5th Cir. 1990) (standing for the proposition that no presumptions should be made with regard to the controlling person status of persons because they were corporate directors of a primary Securities Acts violator).

11 For example, some courts have required "culpable participation" (active involvement in the controlled person's Securities Acts violation) for controlling person liability. See, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 185 (3d Cir. 1981) (holding that section 20(a) requires "culpable participation" in the securities violation); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc) (concluding that

cause of the failure of the federal courts to develop uniform, coherent approaches to these two questions, sometimes confusing and frequently questionable results have emerged in cases decided under sections 15 and 20(a).¹² Moreover, the courts' treatment of the controlling person determination and defense to liability issues can be characterized as cursory, since most opinions dealing with them offer little meaningful exploration of policy considerations. A cohesive, purposeful body of law has yet to develop under the controlling persons provisions.

This Article examines controlling person determination and liability, and offers approaches to help resolve some of the major uncertainties that have plagued judicial construction of sections 15 and 20(a). The focus will be on plausible interpretations in light of statutory language, legislative history and context, case law, and policy considerations. Part II examines the background of the controlling persons provisions. Part III focuses on the nature of the relationship between a primary violator of the Securities Acts and another person that should render the latter a "controlling person." Part IV considers the defenses to liability under sections 15 and 20(a). In Part V, several hypothetical situations involving potential liability under the controlling persons provisions are explored. Part VI considers the implications of sections 15 and 20(a) for various persons. Finally, in Part VII, a brief conclusion is set forth.

II. BACKGROUND

Investigation of the stock market crash of 1929 exposed the fact that during the 1920s and continuing into the 1930s, fraudulent and manipulative activities accompanied much of the distribution of and trading in securities.¹³ Because the true condition of and prospects

directors could not be liable under section 20(a) unless they were culpable participants in the fraud perpetrated by controlled persons).

Other circuit courts have not required "culpable participation." See, e.g., *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992); *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 897 (10th Cir. 1992), *rev'd sub nom. on other grounds*, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (holding that the language of the statute premises liability on the control relationship, so that culpable participation is not required); *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990) (holding that the failure of a brokerage firm to maintain an adequate system of internal control may be a basis for liability under section 20(a)).

¹² *SEC v. Savoy Indus.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978) (noting that the judicial interpretation of section 20(a) has "hardly been a history of consistency").

¹³ See H.R. REP. NO. 73-85, at 2 (1933) ("High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.").

for many investment vehicles were obscured or misrepresented,¹⁴ large quantities of unsound securities were distributed to the frequently uninformed and misinformed investing public.¹⁵ Determined to eradicate unseemly and unsound securities activities and practices, the Roosevelt administration¹⁶ and Congress sought comprehensive federal legislation to bring an end to such practices and to restore public confidence in the securities markets.¹⁷ Their efforts culminated with passage of the Securities Acts. In this legislation, Congress imposed primary civil¹⁸ and criminal liability¹⁹ on the *direct perpetrators* of fraudulent and manipulative conduct in securities transactions.

Congress also included sections 15 and 20(a) in the Securities Acts to provide for the potential liability of *persons controlling the direct perpetrators* of fraudulent and manipulative conduct in securities transactions. The specter of persons reaping benefits from such conduct while being insulated from liability was perceived to be part of the reason for the erosion of confidence in the securities markets.²⁰ It was necessary for Congress to include specific controlling persons liability provisions in the Securities Acts because many persons with control over direct perpetrators of securities fraud might otherwise have

14 See *id.* ("Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security.").

15 One half of the nearly 50 billion dollars worth of securities sold in the United States between 1920 and 1933 were worthless by 1933. 1 LOUIS LOSS & JOEL SELIGMAN, *THE FUNDAMENTALS OF SECURITIES REGULATION* 169 (3d ed. 1995).

16 It was a Roosevelt administration draft bill that formed the basic framework for what eventually became the Securities Act. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 52 (1982).

17 See MICHAEL PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 3 (1970) ("For many New Dealers like Frankfurter, and for Roosevelt himself, financial regulation was central to the New Deal. Making capitalism live up to its pretensions necessitated a restoration of public confidence in the governing symbols and basic currency of the economic order—investment securities."); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) ("Investment bankers, brokers and dealers, corporate directors, accountants, all found themselves the object of criticism so severe that the American public lost much of its faith in professions that had theretofore been regarded with a respect that had approached awe.").

18 See, e.g., 15 U.S.C. § 771(1) (1994). A seller of securities in violation of section 5 of the Securities Act may be liable to purchasers pursuant to section 12(1) of the Securities Act.

19 See, e.g., 15 U.S.C. § 78ff (1994). Under section 32(a) of the Exchange Act, anyone who solicits proxies by means of false or misleading proxy materials may be criminally liable.

20 See Landis, *supra* note 17, at 30.

continued to be immune from liability, in light of applicable legal principles.²¹ The direct participation required to sustain a cause of action for a primary violation based on malfeasance or misfeasance could have been avoided or disguised by many persons with control.²² Further, primary Securities Acts liability based on nonfeasance would have been available only in certain circumstances, which may not have included many control relationships.²³

Where, as frequently would be the case, the primary Securities Acts violators were corporations, establishing a causal link between securities violations and controlling persons would have been especially difficult in light of traditional legal principles. Without sections 15 and 20(a), the separate-legal-person status of corporations would have provided an impenetrable shield from liability for some persons who controlled Securities Acts violators. Persons controlling corporations from "inside" and "outside" might have claimed immunity from liability on the ground that any violations of securities laws were committed by the corporation.²⁴ Further, traditional common-law based secondary liability could have been avoided by many controlling persons, inasmuch as it relied on agency principles. In this regard, the conduct of a corporation's agents violative of securities laws could not have been attributed to those who were part of the formal organiza-

21 William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 174 (1933) (explaining that, prior to the enactment of the Securities Act, "[s]atisfaction of the common-law requirements of fraud raised almost insurmountable barriers to recovery").

22 Primary liability under the antifraud provisions of the Securities Acts, generally speaking, will be at least loosely based on common-law principles, unless express statutory language provides otherwise. See generally *Chiarella v. United States*, 445 U.S. 222 (1980). Most bases of common-law fraud liability required and continue to require either malfeasance, misfeasance, or nonfeasance. Malfeasance and misfeasance require an affirmative act on the part of the wrongdoer. It would have been difficult to show the requisite kind of manifest affirmative acts by controlling persons in many cases involving securities fraud, since other persons would have been "acting." See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS §§ 106-07 (5th ed. 1984). While the discussion here focuses on the circumstances extant at the time of the passage of the Securities Acts, the common-law fraud requirements have remained essentially unchanged.

23 Under traditional legal principles nonfeasance cannot be a basis for liability for fraud unless defendant owes a "special duty" to plaintiff. See *id.* at 376. Many control relationships, however, would not be within the special duty exceptions recognized at common law. RESTATEMENT (SECOND) OF TORTS §§ 314, 314A (1965); see also KEETON, *supra* note 22, at 376.

24 In an agency relationship the principal is the one for whom the action is to be taken. RESTATEMENT (SECOND) OF AGENCY § 1(2) (1958). The firm is the principal on whose behalf enterprise activities are undertaken.

tional hierarchy—shareholders, directors, and dominant officers—on the basis of agency, because the principal in the agency relationship would have been the corporation.²⁵ Evidence of an agency relationship between primary Securities Acts violators and persons external to an enterprise (persons not part of the formal organizational hierarchy) rarely would have been readily available to potential plaintiffs.

To a quite limited extent, the Securities Act addressed some of the potential defenses to primary and secondary liability directly by specifically placing some responsibility and potential liability on directors.²⁶ Such an approach was consistent with the mandate of corporation law statutes. Under these statutes the business and affairs of corporate enterprises were to be managed by the board of directors.²⁷ In reality, however, by the 1930s corporate control was manifesting itself in some ways not contemplated by corporate statutes and in some ways theretofore unknown.²⁸

By the 1930s, effective control of many enterprises did not rest with the board of directors, but rather was in the hands of profes-

25 *Id.*

26 See section 11 the Securities Act, stating:

(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material act required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity . . . sue

....

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted

....

15 U.S.C. § 77k (1994).

Greater express responsibility and liability for directors would add little to the effectiveness of the statutory framework if those with control could rely on the legal powers of directors to act "independently" to insulate them from liability. Where boards were populated by "dummies" lacking deep pockets, evasion of meaningful responsibility and liability could be completed with relative ease.

27 Corporation statutes in this era typically provided that the business and affairs of the corporation were to be managed by the board of directors. See EDWARD S. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 30-32 (1981). Eventually, corporation statutes were amended to provide that corporations are to be managed "by or under the authority of . . . its board of directors." REV. MODEL BUS. CORP. ACT § 8.01(b) (1984) (emphasis added); see also DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."). This change was made to reflect the realistic limitations on the ability of directors to actually "manage" the large decentralized firm.

28 See HERMAN, *supra* note 27, at ch. 3.

sional officers/managers who controlled the proxy machinery,²⁹ or with "outside" forces with financial and other leverage that enabled them to dictate corporate policies.³⁰ In management dominated companies, the boards often were populated by compliant directors.³¹ Enterprises controlled externally frequently had boards dominated by those outside forces that saw to it that the board marched to their tune.³² Thus, by the 1930s the boards of many companies were populated by "dummy" directors with fealty to inside or outside forces controlling them, but with no real commitment to independent stewardship of their enterprises.³³ Hence, with respect to an enterprise or related group of enterprises, those persons controlling corporate decision-making processes and personnel frequently were not the directors but other persons in a variety of relationships—internal and external—with the organization. Many of these controlling persons effectively would have been shielded from primary liability for securities fraud because of the difficulty of establishing causation under traditional legal principles.³⁴ Further, they would not have been exposed to any secondary liability, since no basis existed for such liability under extant legal principles.³⁵

In light of this background, it seems reasonable to surmise that Congress included sections 15 and 20(a) in the Securities Acts to address the obstacles to controlling person liability for securities fraud posed by extant liability principles and evolving patterns of corporate governance. Congress determined that to be effective against the fraudulent and deceptive securities practices rampant in the 1920s and early 1930s, a comprehensive scheme of securities regulation required inclusion of measures specifically designed to place some responsibility and potential liability on persons controlling primary violators of the regulatory scheme.

The initial efforts to bring controlling persons within the purview of federal securities regulation appeared in the original Senate ver-

29 As corporations grew in size and ownership was distributed among increasingly large numbers of shareholders, policy decisions and daily operations were removed to managers. See ALFRED D. CHANDLER, *THE VISIBLE HAND* 9-10 (1977).

30 See HERMAN, *supra* note 27, at 13, 22 (discussing financial institutions as control vehicles); BARRIE A. WIGMORE, *THE CRASH & ITS AFTERMATH* 41 (1985) (describing the role of holding companies in corporate control).

31 See generally William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

32 H.R. REP. NO. 73-152, at 12 (1933); see, e.g., WIGMORE, *supra* note 30.

33 Douglas, *supra* note 31.

34 See *supra* notes 21-24 and accompanying text.

35 See *supra* note 25 and accompanying text.

sion of what was to become the Securities Act.³⁶ That proposal contained provisions that were intended to "do away with the . . . dangerous and unreliable system of depending upon dummy directors who have no responsibility."³⁷ It reflected congressional concern about the use of "other persons" to avoid responsibility and liability for malfeasance, misfeasance, and nonfeasance in connection with securities transactions. Section 13 of the original Senate bill would have made so-called dummy³⁸ directors as well as their controlling persons liable for fraud perpetrated by corporations through the use of dummies.³⁹

When the House and Senate bills were reconciled and a compromise was agreed upon, the idea behind the Senate provision on dummy directors emerged in a new measure that provided for controlling person liability.⁴⁰ The conference committee deleted references to dummies from the final bill.⁴¹ Instead, section 15 of the Securities Act imposed liability on *any* person who controlled a person liable under sections 11 or 12 of the Act.⁴²

36 S. 875, 73d Cong. (1933).

37 S. REP. NO. 73-47, at 5-6 (1933); see *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.) Before the Senate Comm. on Banking and Currency, (pt. 15), 73d Cong. 6556 (1934)* (remark of Senator Alben W. Barkley).

38 "Dummy" was defined in the bill as amended to mean:

[A] person who holds legal or nominal title to any property but is under moral or legal obligation to recognize another as the owner thereof; or a person who has nominal power or authority to act in any capacity but is under moral or legal obligation to act therein in accordance with the direction of another.

S. 875, 73d Cong. § 2(k) (1933), *reprinted in* 77 CONG. REC. 2979 (1933).

39 The draft proposal provided that:

It shall be unlawful for any person, firm, corporation, or other entity . . . to employ any "dummy", or to act as any such "dummy", with the intent to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction . . . relating to the . . . purchase or sale of any securities which operates or would operate as a fraud upon the purchaser. The director or other person for whom any "dummy" shall act shall be held responsible under this act for any unlawful conduct by such "dummy."

S. 875, 73d Cong. § 13 (1933), *reprinted in* 77 CONG. REC. 2982 (1933).

40 H.R. REP. NO. 73-152, at 12 (1933). The original House of Representatives' version did not contain a "dummy" provision. The House version did provide for the imposition of liability on directors for false or deceptive representations.

41 *Id.*

42 Securities Act of 1933, ch. 38, § 15, 48 Stat. 74, 84 (1933) (current version at 15 U.S.C. § 77o (1994)). As originally enacted, section 15 read: "Every person who, by or through stock ownership, agency, or otherwise . . . controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent

Section 15, as originally enacted, was criticized as being overly broad because, in effect, it imposed an "insurer's" liability on controlling persons, since it provided for no defense to liability.⁴³ Responding to this criticism, Congress, in 1934, amended section 15 to provide a statutory defense to controlling person liability.⁴⁴ At the same time that Congress amended section 15 of the Securities Act, it incorporated a differently worded controlling person provision, section 20(a), into the Exchange Act.⁴⁵

While sections 15 and 20(a) are worded differently, it is clear that their fundamental purposes are the same.⁴⁶ Both provisions are designed to provide for responsibility and liability for persons controlling primary Securities Acts violators, *regardless of their identity*. By expressly making all such persons potentially liable, Congress precluded much of the use of traditional legal principles to shield controlling persons from liability for Securities Acts violations.⁴⁷ Under sections 15 and 20(a), intra- as well as extra-organizational barriers can be penetrated to hold controlling persons liable, regardless of their identity, for the Securities Acts violations of their controlled persons.

III. DETERMINATION OF CONTROLLING PERSON STATUS

A. Overview

Defendants in sections 15 and 20(a) actions may avoid liability on the ground that they were not controlling persons.⁴⁸ Alternatively, even if they are determined to be controlling persons, they will avoid liability if they can establish the statutory defenses.⁴⁹ Thus, initially in a section 15 or section 20(a) action, a determination must be made with respect to whether each defendant is a "controlling person." Section 15 describes a controlling person as "every person who controls

as such controlled person to any person to whom such controlled person is liable." *Id.*

⁴³ See *id.*

⁴⁴ Securities Exchange Act of 1934, ch. 404, § 208, 48 Stat. 881, 908 (1934) (current version at 15 U.S.C. § 77o (1994)). The amendment added to the section the following language: "unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." *Id.*

⁴⁵ Securities Exchange Act of 1934, ch. 404, § 20(a), 48 Stat. 881, 899 (1934) (current version at 15 U.S.C. § 78t(a) (1994)).

⁴⁶ *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.) Before the Senate Comm. on Banking and Currency*, 73d Cong., at 6571 (1934).

⁴⁷ See *supra* notes 21-25 and accompanying text.

⁴⁸ See *supra* note 9 and accompanying text.

⁴⁹ See *supra* note 9 and accompanying text.

by or through stock ownership, agency or otherwise.”⁵⁰ A controlling person under section 20(a) is described as “every person who controls directly or indirectly,”⁵¹ while its legislative history lists “stock ownership, lease, contract and agency”⁵² as examples of bases upon which a person can be determined to be a controlling person.⁵³ Thus, Congress has identified some of the means by which a person may have control within the purview of sections 15 and 20(a). Congress has not, however, offered a definitive formula for determining whether in a particular context a person is a controlling person.

The legislative history of the controlling persons provisions does indicate that Congress deliberately declined to fix exclusive criteria for controlling person determinations under sections 15 and 20(a). It was thought that the concept of controlling person under the sections should remain flexible enough to meet a wide variety of situations, including those that could not be foreseen at the time of the measures’ enactments.⁵⁴ Congress left to the federal courts the task of making controlling person determinations in particular cases. Given the lack of clear congressional direction, perhaps it is not surprising that there is conflict, controversy, and a great deal of uncertainty surrounding the question of how to determine whether a person is a controlling person within the purview of sections 15 and 20(a).⁵⁵ One important question that has divided courts concerns what role a person’s status or position should play in a controlling person determination. Is the mere possession of the right to control a sufficient basis for concluding that a person is a controlling person, or must there have been some significant, manifest exercise of control over the primary Securities Acts violator?⁵⁶ Other important questions include

50 15 U.S.C. § 77(o) (1994).

51 15 U.S.C. § 78t(a) (1994).

52 H.R. REP. NO. 73-1383, at 26 (1934).

53 The two provisions do use different language to describe controlling persons. This difference does not seem to be significant, since the two descriptions are not at odds, and courts and commentators have not suggested that a controlling person determination would be affected by which of the two provisions is at issue.

54 For example, “control” is not defined in sections 15 and 20(a). This declination was intentional. Congress announced that “[i]t was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted.” H.R. REP. NO. 73-1383, at 26 (1934).

55 Shortly after the passage of the Securities Act, commentators noted that the controlling persons provisions would clearly reach majority shareholders, but that the further reach of “control” was uncertain. See, e.g., Douglas & Bates, *supra* note 21, at 191.

56 See *supra* note 10 and accompanying text.

whether there can be more than one controlling person with respect to the same primary violator and whether or under what circumstances a group can be a controlling person. Moreover, the highly generalized consideration of controlling person determinations found in the case law and commentary offers little clue as to how the answers to a myriad of critical questions might or should change depending on whether the context involves publicly held or privately held enterprises. For example, are outside directors and executive officers of large corporations controlling persons within the purview of sections 15 and 20(a), notwithstanding the fact that decentralized management results in significant securities activities taking place without their direct participation? That there is some disagreement or uncertainty about the answers to such basic questions is indicative of a fundamental absence of consensus about the nature of the control addressed by sections 15 and 20(a).

B. General Considerations

Control is a rather elusive concept that has been variously defined. The Securities and Exchange Commission has defined it as follows:

The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the *power* to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.⁵⁷

This definition is an appropriate starting point for our analysis, since it focuses on *power* without attempting to limit its coverage to any specifically identified persons. Congress wished to address abuses by those with power over primary violators of the Securities Acts, regardless of the controlling person's identity, with its passage of sections 15 and 20(a).⁵⁸

Power refers to the capacity of its possessor to enforce its will over the object of its power, should it choose to exercise it.⁵⁹ If *A* has the capacity to enforce its will in a way that can cause *B* to act in a way *B* otherwise would not have, *A* has power over *B*.⁶⁰ Power is at the core

57 17 C.F.R. § 230.405 (1995) (emphasis added).

58 See *supra* note 47 and accompanying text.

59 PAUL HERSEY & KENNETH H. BLANCHARD, *MANAGEMENT OF ORGANIZATIONAL BEHAVIOR UTILIZING HUMAN RESOURCES* 43 (6th ed. 1993).

60 ALAN C. FILLEY, ET AL., *MANAGERIAL PROCESS AND ORGANIZATIONAL BEHAVIOR* 92 (2d ed. 1976).

of control.⁶¹ Power may be based on authority,⁶² by which I mean the legal right to control.⁶³ The bases or sources of authority are found in statutes, regulations, rules, and customs.⁶⁴ Where control is legitimized by statute, regulation, rule, or custom in the sense that the control would be sustained on such basis if subject to challenge, authority exists. The capacity of *A* to cause *B* to act in a way *B* would not otherwise act may also be based on factors other than authority.⁶⁵ De facto (actual) control may be possessed by other persons with significant bases of power, other than authority, that provide them with the capacity to compel *B* to act in a prescribed way.⁶⁶

These observations about the nature of control have particular relevance for an analysis of the controlling persons provisions. This seems clear from the single paragraph that constitutes the only direct legislative history (that found in a legislative report) regarding the meaning of control under the controlling persons provisions: "In this section [20(a)] . . . when reference is made to 'control', the term is intended to include actual control as well as what has been called legally enforceable control."⁶⁷ In *Handy & Harmon v. Burnet*, the Supreme Court discussed "a kind of control called . . . 'actual' to distinguish it from a legally enforceable control."⁶⁸ It can be noted that "a legally enforceable control" has a de jure, as opposed to a de facto, basis and thus is encompassed by authority.⁶⁹ This de jure/de facto distinction is particularly useful for controlling person determinations. *Authority to control* and *actual control* should be considered as alternative tests, either one of which may provide a basis for determining that a particular person is a controlling person within the purview of sections 15 and 20(a).

61 AMITAI ETZIONI, *MODERN ORGANIZATIONS* 59-60 (1964).

62 FILLEY, *supra* note 60, at 93.

63 *Id.*

64 *Id.* at 93-94. Organizations operate in their own internal legal framework in addition to the applicable external legal framework that applies to all persons as well as external law (corporate statutes) specifically addressed to organizations. Organizational bylaws are perhaps the most important manifestation of express organizational rules. Of course, there are customary rules that apply to most organizations as well as informal rules particular to an organization.

65 *See infra* notes 121-40 and accompanying text.

66 *See* ETZIONI, *supra* note 61, at ch. 6.

67 H.R. REP. NO. 73-1383, at 26 (1934) (citing *Handy & Harmon v. Burnet*, 284 U.S. 136 (1931)).

68 *Handy*, 284 U.S. at 140.

69 ELLIOTT JAKES & STEPHEN D. CLEMENT, *EXECUTIVE LEADERSHIP: A PRACTICAL GUIDE TO MANAGING COMPLEXITY* 10-11 (1991); *see also* GARETH MORGAN, *IMAGES OF ORGANIZATION* 158-60 (1986).

There may be more than one controlling person of a primary Securities Acts violator since there may be several loci of control, within the purview of sections 15 and 20(a), in a particular organizational framework. The retention of *authority to control* by one person does not preclude *actual control* by other persons having power that can be determinative with regard to the course of conduct of a particular controlled person. Persons with authority to control may delegate it wholly or partially and those with delegated authority may control pursuant to their delegation, subject to being restrained or countermanded by their delegator.⁷⁰ For example, though corporate officers may obtain considerable authority through board of director delegations, the board ordinarily retains the inherent authority to countermand them.⁷¹ Such delegation and reservation of authority to control is consistent with general corporate organizational norms,⁷² under which executive officers manage corporate affairs while their performance in that regard is monitored by the board of directors.⁷³ Further, although persons may have the authority to control a person—authority that would be sustained at law if challenged—other persons also may have the power to assume or exert some de facto control (actual control) over that same person.⁷⁴ Hence, though the board of directors has the authority to control a corporation, some of

70 See *infra* note 106 and accompanying text.

71 See JAKUES & CLEMENT, *supra* note 69; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02 cmt. f (A.L.I. 1994) [hereinafter ALI, CORPORATE GOVERNANCE] (recognizing that “ultimate responsibility for approving major corporate plans and actions is vested in the board”).

72 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 cmt. a (“[T]he board can normally satisfy the requirements of present statutes without either actively managing or directing the management of the corporation, as long as it oversees management and retains the decisive voice on major corporate actions.”); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 311 (1983). Formal resolutions, informal communications, and acquiescence are all vehicles for delegations of authority from the board of directors to executive officers.

73 While the focus herein is on the corporate organizational framework, many observations will apply by analogy in other organizational frameworks. Hence, the management committee and the managing partner would be substituted for the board of directors and president where the organizational context is one of partnership rather than corporation.

74 See, e.g., *United States v. Wolfson*, 405 F.2d 779, 781 (2d Cir. 1968) (finding that, although Wolfson was not an officer or director, he was a controlling person because he was the corporation’s largest individual shareholder (though still a minority shareholder), the officers of the corporation were under his control, and no policy decisions were made without his approval); *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395, 400-01 (S.D.N.Y. 1957) (finding a person to be controlling, despite the fact that he was neither an officer nor a director, because he exercised de facto control over the corporation through a relative).

this power may be relinquished, for example, by allowing a creditor to control some of the organization's monitoring or managing functions.⁷⁵

In larger organizations, authority to control may be split along divisional lines so that different persons have the right to control different divisions. Similarly, authority to control may be split along functional lines so that one function, such as management of day-to-day operations, might be under the authority of one person while another function—for example, long range business planning and policy matters—might be under the authority of another person or persons.⁷⁶ Such segmentations of authority to control in a particular organizational framework would not preclude other persons having actual control with respect to a particular segment.

It also seems clear that groups may have control within the purview of sections 15 and 20(a).⁷⁷ The board of directors and committees thereof are groups that appropriately may be designated controlling persons of corporate organizations based on their authority to control.⁷⁸ The more complex the organizational framework, the more likely it is that the managerial functions executive officers are authorized to perform, of necessity, will be shared.⁷⁹ Group control, however, need not be based on shared authority. There may be actual control by a group within the purview of sections 15 and 20(a). The characteristics of such a group cannot be described with certainty in the abstract, but it should possess the requisite power and should reflect cohesion and action in concert for a common purpose before it

75 See *infra* notes 360-65 and accompanying text.

76 Cf. Fama & Jensen, *supra* note 72, at 308 (maintaining that in complex organizations, efficient decision control involves delegation and diffusion of decision control among agents with specific knowledge as well as separation of decision management and control at different levels of an organization).

77 A.A. Sommer, Jr., *Who's "In Control"?*—S.E.C., 21 BUS. LAW 559, 576-83 (1966); see also Irving L. Janis, *Groupthink*, 5 PSYCHOL. TODAY, Nov. 1971, at 43.

78 See REV. MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation."); *id.* § 8.25(a) ("Unless the articles of incorporation or bylaws provide otherwise, a board of directors may create one or more committees and appoint members of the board of directors to serve on them. Each committee must have two or more members, who serve at the pleasure of the board of directors."); *id.* § 8.25(d) ("To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the authority of the board of directors under section 8.01.").

79 See DAVID M. KOTZ, *BANK CONTROL OF LARGE CORPORATIONS IN THE UNITED STATES* 16-17 (1978); Fama & Jensen, *supra* note 72, at 308-09.

appropriately may be categorized as a controlling person.⁸⁰ It is appropriate to classify each member of a controlling group as a controlling person—whether group control is based on authority, actual control, or some combination thereof—unless a member takes steps to disassociate from the group.

To the extent possible, a controlling person determination should distinguish between control and mere influence.⁸¹ Various kinds of skills, traits, and relationships may provide a person with some measure of influence,⁸² but influence is not power to exact compliance.⁸³ While persons with influence can help persuade, persuasion is not command. Persons with control may have been appealed to, advised, or counseled by a person with mere influence, but their decisionmaking will not have been overborne by a person with mere influence. A decision made or action taken may, in whole or in part, be due to the influence of a particular person; however, unless it has been compelled by some enforceable power of that person, they should not be considered to be controlling persons within the meaning of sections 15 and 20(a). The influencer or persuader will not have forced the decision or action violative of the Securities Acts and hence should not face potential liability for it under the controlling persons provisions.⁸⁴

Moreover, to include persons with mere influence within the controlling person definition would dilute the concept and increase litigation without corresponding benefits in terms of achieving the goals of sections 15 and 20(a). All evidence points to congressional concern

80 See Sommer, *supra* note 77.

81 I use the term "mere influence" to describe influence not backed by enforceable power. It can be distinguished not only from control but also from "controlling influence," a term sometimes used (though not herein) to describe a form of power to control. See Edwin P. Hollander, *Legitimacy, Power, and Influence: A Perspective on Relational Features of Leadership*, in LEADERSHIP THEORY AND RESEARCH 29, 31 (Martin M. Chemers & Roya Ayman eds., 1993); cf. FILLEY, *supra* note 60, at 93 (defining influence as "the capacity of A to get B to do something B would otherwise not have done without resorting to the manipulation of rewards and punishments").

82 FILLEY, *supra* note 60, at 94.

83 Hollander, *supra* note 81, at 31.

84 As Edwin Hollander observes:

Power and influence are not the same, although they are at times used as virtual synonyms. Classically, power is considered to be the ability to exert some degree of control over other persons, things and events. In institutional terms, it is associated with authority relationships, and actual or implied coercion. By contrast, influence involves more persuasion, with the recipient having latitude for a free choice, rather than be subject to imposed authority.

about power-based control as opposed to mere influence.⁸⁵ There is no evidence in the records of the efforts of the Roosevelt administration or Congress to suggest that sections 15 and 20(a) were somehow aimed at persons with mere influence. Congress seemingly was more concerned with the substantial threat posed by persons with *authority to control* who default on their responsibility for Securities Acts compliance and by other persons with significant power bases who manifest their *actual control* without due regard for Securities Acts compliance. Hence, the concerns of Congress reflected in its enactment of sections 15 and 20(a) can be met without expanding the controlling person concept to encompass mere influence.

Further, controlling person status should not extend to so-called transitive relationships.⁸⁶ For example, assume that an investment banker is on the board of directors of an industrial company. While the individual director may be presumed to be a controlling person under sections 15 and 20(a) as a member of the controlling group,⁸⁷ his firm should not be deemed a controlling person solely on the basis of the individual member's directorship. In this context, the power is in the directors as a group, not in the group's individual members. In the absence of evidence that the investment firm somehow controlled the majority of the board members or evidence that it had other bases of power, the firm should not be within the purview of sections 15 and 20(a).⁸⁸

C. *Controlling Person Status Based on Authority to Control*

In corporate organizational frameworks, several persons can be identified as ordinarily having authority to control that should render them controlling persons within the meaning of sections 15 and 20(a). For starters, corporate entities are controlling persons in light

85 See *supra* notes 57-69 and accompanying text.

86 Plaintiffs have attempted to advance the argument that any company that has control over an entity's control person is also a controlling person of that entity. Courts have rejected this argument. See *In re Jenny Craig Sec. Litig.*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,337 (S.D. Cal. 1992) (holding that an underwriter was not a "control person" although it had appointed one individual to issuers' board of directors and held a minority stock position in issuer); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140, 1149 (N.D. Cal. 1989) (holding that a venture capitalist who was a shareholder of a corporate issuer and had a representative on the issuer's board was not a controlling person of the issuer).

87 See *supra* notes 77-78 and accompanying text.

88 To the extent that the individual director is liable, his firm is potentially liable under common-law agency principles—not under sections 15 and 20(a). See *Blau v. Lehman*, 368 U.S. 403 (1962).

of the fact that they own their assets and are legally responsible for them.⁸⁹ Further, they have the right or authority to control the conduct of their agents engaged in conducting their business and affairs.⁹⁰

Persons with the authority to control the corporation's "direction of . . . management and policies" would be controlling persons thereof.⁹¹ Ordinarily, this "direction" is set within corporations by those persons authorized to control organizational decision-making processes.⁹² Organizational decision-making processes have been characterized as having four steps: initiation, ratification, implementation, and monitoring.⁹³ Initiation involves the generation of proposals for organizational endeavors, while *ratification* involves the process of approving which of the initiatives are to be implemented.⁹⁴ Implementation can be described as the execution or *management* of organizational policies and decisions, while *monitoring* involves oversight of those implementing or managing organizational policies and decisions.⁹⁵ The primary control functions in corporate organizations are *ratification* and (especially) *management* and *monitoring*.⁹⁶

The decisional actors within formal organizational hierarchies with *authority* to ratify, manage, and monitor are majority shareholders, boards of directors, and executive officers. Majority shareholders of an enterprise own it indirectly through their shareholdings.⁹⁷ They have authority to ratify and monitor with regard to certain organizational personnel and affairs because they have the legal right to select⁹⁸ and remove directors⁹⁹ and to veto significant proposed

89 KOTZ, *supra* note 79, at 1-22.

90 RESTATEMENT (SECOND) OF AGENCY § 14 (1958). The agent has a corresponding duty to obey directions of the principal with respect to matters within the agency. *Id.* § 385(1).

91 See *supra* note 57.

92 Fama & Jensen, *supra* note 72, at 301-11.

93 *Id.* at 303.

94 *Id.*

95 *Id.*

96 *Id.* at 303-04.

97 KOTZ, *supra* note 79, at 19-20.

98 DEL. CODE ANN. tit. 8, § 216(3) (1991) ("Directors shall be elected by a plurality of the votes of the shares . . ."); REV. MODEL BUS. CORP. ACT § 7.28(a) (1984) ("Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which quorum is present").

99 DEL. CODE ANN. tit. 8, § 141(k) (1991) ("Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares . . ."); REV. MODEL BUS. CORP. ACT § 8.08(a) (1984) ("The shareholders may

corporate changes of a structural nature.¹⁰⁰ The board of directors has legal authority over all the business and affairs of a corporation.¹⁰¹ Ordinarily, the board ratifies significant initiatives of executive officers,¹⁰² monitors their management performance,¹⁰³ considers and reviews major transactions,¹⁰⁴ and generally monitors significant developments in the enterprise.¹⁰⁵ Executive officers have authority over "ordinary" organizational affairs within their domain and such other authority as is delegated to them.¹⁰⁶ Additionally, executive officers initiate major policies and practices, for directorial ratification, and manage the implementation of organizational policies and programs.¹⁰⁷

This description of how organizational authority to control typically is distributed among the various corporate actors should not obscure the possible variations. For example, in many closely held corporations, integration of organizational control roles is the rule—

remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause . . .").

100 See, e.g., REV. MODEL BUS. CORP. ACT § 11.01(a) (1984) ("One or more corporations may merge into another corporation if the board of directors of each corporation adopts and its shareholders (if required by section 11.03) approve a plan of merger."); *id.* § 12.02(a) ("A corporation may sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property (with or without the good will), otherwise than in the usual and regular course of business, on the terms and conditions and for the consideration determined by the corporation's board of directors, if the board of directors proposes and its shareholders approve the proposed transaction."); *id.* § 14.02(a) ("A corporation's board of directors may propose dissolution for submission to the shareholders."); *id.* § 14.02(b)(2) ("For a proposal to dissolve to be adopted . . . the shareholders entitled to vote must approve the proposal to dissolve . . ."); see also DEL. CODE ANN. tit. 8, § 251(c) (1991) (requiring that a merger agreement "be submitted to the stockholders of each constituent corporation"); *id.* § 271(a) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, including its goodwill and its corporate franchises . . . when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation."); *id.* § 275(b) ("If a majority of the outstanding stock of the corporation entitled to vote thereon shall vote for [a] proposed dissolution, a certificate of dissolution shall be filed with the Secretary of State.").

101 See *supra* note 27.

102 Fama & Jensen, *supra* note 72, at 311.

103 *Id.*

104 *Id.* at 313.

105 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 (detailing the functions and powers of the board of directors); ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 483 n.1(a) (5th ed. 1994).

106 Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 9-12 (1989).

107 KOTZ, *supra* note 79, at 14-17.

active involvement by shareholders in the managing and monitoring of the full panoply of corporate policies and practices can be expected.¹⁰⁸ On the other hand, a direct management role by shareholders would be rare in a publicly held corporation.¹⁰⁹ In some larger enterprises, executive officers function much like the textbooks suggest that outside directors function: largely playing a monitoring role while limiting their direct management to significant corporate events.¹¹⁰ While there are variations among corporations with regard to which of the persons with authority exercise organizational ratifying, managing, and monitoring functions, those exercising such authority will be the organization's decisional actors—majority shareholders, directors, and officers.

Therefore, a person should be presumed to be a controlling person under sections 15 and 20(a) if they occupy a status or position that ordinarily bestows *authority to control* the primary violator generally, or specifically with respect to the matter or affairs that produced the Securities Acts violation. They should be presumed to be controlling persons if they are corporations, majority shareholders, directors, or executive officers.¹¹¹ All such persons have authority to control organizational affairs and personnel,¹¹² as well as certain de jure duties and responsibilities in that regard.¹¹³ A section 15 or 20(a) complaint based on authority to control, then, should not have to make specific allegations concerning any actual exercise of control by the defendant over the Securities Acts violator. Plaintiffs, however, should be required to identify the de jure source of authority to control—the status or position—and allege conduct that facilitated the Securities Acts violations, or allege a failure to exercise authority to prevent the violations, or both. The presumption of controlling person status, based on occupying a position or status that ordinarily conveys authority to control, should be rebuttable by a showing of a lack of authority in fact or that other persons controlled the primary violators to the exclusion of defendants.¹¹⁴ If the theory of control by authority is based

108 HAMILTON, *supra* note 105, at 457-69.

109 *Id.* at 483 n.1.

110 Hamilton, *supra* note 106, at 10-11.

111 See *supra* notes 62-64 and accompanying text.

112 FILLEY, *supra* note 60, at 94-95.

113 HAMILTON, *supra* note 105, at ch. 10-11.

114 See, e.g., *Herm v. Stafford*, 466 F. Supp 439 (W.D. Ky. 1979), *rev'd in part, aff'd in part*, 663 F.2d 669 (1981) (holding that an employee who supervised stores but had no role in policy matters, who read corporate materials stating he was Vice President but never agreed to become an officer, and who was not in a position to participate in securities violations was not a controlling person).

on group control, a definitive act of disassociation from the group or the group's role in the subject violations should allow for severance from the defendant group by the disassociating member.¹¹⁵

The presumption of controlling person status for persons with organizational authority, suggested herein, is based in part on a recognition that a person occupying a position that ordinarily conveys the authority to interdict Securities Acts violations has, at least in theory, control within the purview of sections 15 and 20(a). It is conceded that status as a corporation, majority shareholder, director, or executive officer, as a practical matter, would in many cases present no meaningful opportunity to detect and/or interdict particular violations of the Securities Acts, even with the most conscientious effort. Nonetheless, it is appropriate that the burden of making such a showing should be placed, during the defense phase of a controlling person action, upon those persons who have voluntarily assumed a status or position that ordinarily conveys certain authority to control. Such persons should not be encouraged to ignore the duties and responsibilities—fiduciary and otherwise—attendant to that control. Indeed, the initial concern that led to the enactment of section 15 focused on the abdication of responsibility by persons clothed with *authority*—corporate directors.¹¹⁶ These same considerations justify presuming controlling person status for persons occupying authority to control positions even though some such persons will, in fact, have lacked the power to control the primary Securities Acts violators in the particular organizational framework, because they lacked authority in fact or because other persons controlled to their exclusion.

Moreover, the presumptions suggested herein are justified because a full evaluation of control under sections 15 and 20(a) frequently will involve some difficult and subjective judgments.¹¹⁷ In the early stages of sections 15 and 20(a) actions, plaintiffs may be forced to proceed primarily on the basis of public information. They, understandably, are unlikely to be knowledgeable about the intricacies of intra- and extra-corporate patterns of control in some organizational frameworks. Departures from the usual patterns of control are matters the presumed controlling person is in a superior position to address, relative to the position of the plaintiff. Moreover, analysis of organizational control can be facilitated by subjecting corporate officialdom to discovery, since even if those in positions of authority in an

115 The dissociation option for directors under statute may suggest a model. See *infra* note 311.

116 See *supra* notes 36-39 and accompanying text.

117 See generally Mason Ladd, *Presumptions in Civil Actions*, 1977 ARIZ. ST. L.J. 275.

organization do not in fact control it, they should be able to provide useful information with respect to the persons that do control it.

If persons with authority are unable to overcome the presumption of control, they nonetheless will have an opportunity to avoid liability, since the matters of knowledge and culpability will be considered during the defense to liability phase of a section 15 or 20(a) proceeding.¹¹⁸ Therefore, there is no need to restrict unduly the sweep of controlling person status for those with authority to control, in light of the fact that appropriate restriction on their liability can be found within the sections' defenses. A discerning judgment with respect to the defenses of "lack of knowledge" (section 15)¹¹⁹ and "good faith" and "non-inducement" (section 20(a))¹²⁰ will allow the judicial process to weed out the genuinely blameless in controlling person actions.

D. Controlling Person Status Based on Actual Control

Importantly, the reach of the controlling persons provisions extends beyond persons that are a part of formal organizational hierarchies to any other persons possessing the *power* to control Securities Acts violators.¹²¹ Thus, while corporations, majority shareholders, boards of directors, and executive officers will be a natural focus of attention in a search for controlling persons, in light of their presumptive authority to control, any other persons with the requisite *power* within an organizational framework can be controlling persons within the purview of sections 15 and 20(a) based on their *actual control*.¹²²

For those with authority, the capacity to control is the *de jure* basis that allows or commands them to direct the affairs of the primary violator.¹²³ Capacity for control, likewise, should be the initial significant question in a lawsuit alleging actual control—control based on factors other than authority.¹²⁴ Could the person have directed the cessation of conduct violative of the Securities Acts? Because the existence of actual control may involve complex factual questions, it is difficult to generalize as to when a particular person without authority to control will, nonetheless, be found to have had the power to con-

118 See *infra* Part IV.

119 See *supra* note 4.

120 See *supra* note 5.

121 See *supra* notes 65-69, 74-75 and accompanying text.

122 See *supra* notes 65-69, 74-75 and accompanying text.

123 See *supra* notes 62-64 and accompanying text.

124 See *supra* notes 65-66 and accompanying text.

trol a primary Securities Acts violator. Obviously, such a determination may require a wide-ranging inquiry into the factual setting of the organizational framework. Relevant factors bearing on actual control would include all facts and circumstances that indicate that a person or group could have, if it wished, exercised dominion over the primary Securities Acts violator to end the violative activities. The capacity to "direct . . . the management and policies of a person"¹²⁵ exists where a person or group has any readily available source or sources of power sufficient to enforce compliance with their will.

Shareholdings may provide a source of power that enables their holder to exercise actual control, even when such holdings are less than the majority necessary for legal control (authority to control).¹²⁶ Where there is no majority shareholder and where a shareholder (or shareholders) has a significant quantum of shares, such a person may have sufficient shareholdings to control the enterprise on that basis.¹²⁷ Further, it is the *dominion* over common stock that is important. Therefore, even if those controlling a corporation through shareholdings are not the beneficial owners thereof, they nonetheless may have actual control of the corporation because they can exercise leverage by voting shares they control or by threatening to sell them.¹²⁸

The source of power that provides the basis of *actual control* may be a form of economic clout. It may be reflected by an express contract such as a loan agreement with covenants restricting certain debtor discretion.¹²⁹ Actual control may be based on significant non-

125 See *supra* note 57.

126 ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.10(b); HAMILTON, *supra* note 105, at 604-06. According to the ALI,

A person who, either alone or pursuant to an arrangement or understanding with one or more other persons, owns or has the power to vote more than 25 percent of the outstanding equity securities of a corporation is presumed to exercise a controlling influence over the management or policies of the corporation

Id.

127 *Id.*

128 KOTZ, *supra* note 79, at 19-20; United States Temporary National Economic Committee, *Bureaucracy and Trusteeship in Large Corporations*, Monograph No. 11, 19-23 (1940), in HAMILTON, *supra* note 105, at 604-06.

129 Many covenants and other agreements, of course, would be upheld as binding if challenged. Since, however, they would not be binding to the extent that they impinged significantly on corporate authority consistent with the principles of *McQuade v. Stoneham*, the real power is not so much in the contract as it is in the ability of a provider of economic lucre to withhold it. See *McQuade v. Stoneham*, 189 N.E. 234, 237 (N.Y. 1934) (holding that "a contract is illegal and void so far as it precludes the board of directors . . . from changing . . . [significant] policies"); see also *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 77 N.E.2d 633, 634 (N.Y. 1948) (holding

binding business relationships, since a threat to their continuance may result in one of the parties being compliant with the will of the other. For example, a creditor may have control over a debtor corporation because, though not contractually bound to, the corporation yields the creditor a certain amount of discretion in its governance in the belief that the control surrendered will insure a continuous supply of funds, more favorable credit terms, or both.¹³⁰ It has been suggested that a substantial supplier or customer may be of such consequence to the prosperity of a corporation that it will have the power to dictate certain organizational policies and practices.¹³¹ An employment relationship may provide the employer with actual control over an employee with regard to matters outside the bounds of the employment-based agency.¹³²

Personal relationships may be important variables in controlling person determinations.¹³³ For example, a controlling person's power may be based, in whole or in part, on the ability to wield the power of another person, such as a spouse.¹³⁴ On the other hand, evidence of disharmonious relations may be cited by defendants in sections 15 and 20(a) actions to rebut assertions of group control.¹³⁵

A phenomenon that may be described as "working control" also may provide its possessor or possessors with actual control. Working control¹³⁶ is control in fact that may or may not have a clearly identifiable primary base of power. It may have several bases of power, including some authority. It is a phenomenon that may be explicable

that a shareholder agreement that gave one shareholder, who could not be removed by the board of directors, "full authority and power to supervise and direct the operations of management" of the company's principle business, violated the state's General Corporation Law because it deprived the board of directors of authority over management). Consequently, I have not herein included contract as a basis of *authority to control*.

130 See *infra* Part VI.E.1.

131 Sommer, *supra* note 77, at 573.

132 An employer has *authority to control* an employee within the agency. See *supra* note 90. An employer likely will have *actual control* of an employee with respect to matters outside the scope of the agency because the employee, fearing severance, will comply with his employer's wishes even as to matters "outside" the scope of employment.

133 See *In re MTC Elec. Techs. Shareholders Litig.*, 898 F. Supp. 974, 984 (E.D. N.Y. 1995) (deeming defendant to be a controlling person, in part, because he was son and nephew of two of the most powerful officers of the enterprise); Sommer, *supra* note 77, at 580-81.

134 Sommer, *supra* note 77, at 580-81.

135 *Id.*

136 Adolf A. Berle, Jr., "Control" *In Corporate Law*, 58 COLUM. L. REV. 1212, 1213 (1958).

partially as being quasi-political in nature, since it may exist as a result of the merging of various persons, interests, and power bases into an engine of control. Here, "the proof of the pudding is in the eating." Working control may be possible because no other person or persons either has comparable power or chooses to exercise it. It may be control by default. For example, where shareholding in a corporation is so broadly distributed that no shareholder or group of shareholders has a large enough shareholding base for control, those persons controlling the proxy machinery and solicitation process may utilize that power source in the organization to exercise the kind of control theoretically available to majority shareholders.¹³⁷ Those persons with control of the proxy machinery may in turn nominate, elect, and dominate the board of directors.¹³⁸ While persons with working control may have some organizational authority, such as that of executive officers, their actual control may give them much greater power than that conveyed by their positions of authority.

Relatively little difficulty may be encountered in recognizing factors that could be relevant to a determination that a person has actual control of another. It will not always be easy, however, to determine whether the factors are present in sufficient quantity and intensity to justify designating a person a controlling person within the meaning of sections 15 and 20(a).¹³⁹ Moreover, where there are multiple bases of power, the cumulative effect of the relevant control factors must be evaluated. An appropriate test might be stated as follows: taking into account shareholdings, organizational positions, commercial relationships, personal relationships, and all the other potentially relevant circumstances, what person, persons, or group is likely to have had the power to prevent or end the subject conduct found to be violative of the Securities Acts?¹⁴⁰ If a plaintiff can identify any such persons, other than those with authority, he will have identified persons who may be presumed to be controlling persons under sections 15 and 20(a) on the basis of actual control. This presumption should be rebuttable if defendants convince the tribunal that they did not have the alleged source or sources of power to control the Securities Acts viola-

137 Margaret Hambrecht Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343, 344-45 (1975).

138 ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 86-87 (1993).

139 Rutheford B. Campbell, Jr., *Defining Control In Secondary Distributions*, 18 B.C. INDUS. & COM. L. REV. 37, 49 (1976).

140 Cf. *id.* at 58-59 (examining methods for controlling person determinations); Sommer, *supra* note 77, at 582 (discussing tests for control).

tor or that some other person controlled the violator to their exclusion.

A complaint under section 15 or 20(a) based on *actual control* should be required to: identify the alleged controlling person; identify the primary violator allegedly controlled; identify the source or sources of power upon which the capacity for the alleged actual control is based *or* evidence of the actual exercise of working control; and contain allegations of conduct by the controlling person that facilitated the Securities Acts violation, or allegations of a failure to exercise actual control to prevent the violation, or both. If defendants fail to rebut plaintiffs' evidence of *actual control*, they should be required to meet the statutory defenses in order to escape liability for the Securities Acts violations of their controlled persons.

The relatively automatic presumption of controlling person status for those clothed with authority to control should not—really cannot—apply to a controlling person determination based on actual control. Authority to control can be located relatively easily, since it will be found among the persons that occupy a status or position in the formal organizational framework.¹⁴¹ The essence of the approach advocated herein is that in sections 15 and 20(a) actions based on *actual control*, plaintiffs should be required to make the initial showing of the potential for control by identifying a power base (or bases) that provides defendants with the capacity for control.¹⁴² While identification of a controlling person based on actual control defies reduction to a mechanical process, the focus should be on enforceable power—on the ability to make the controlled person do what they otherwise would not have done.¹⁴³ A more encompassing norm that would allow other factors, such as mere influence, to be “controlling” would be inappropriate, in light of the congressional concern that the Securities Acts might have unintended deleterious consequences for persons merely because they were associated with a violator of the Acts. Too low a threshold for acceptance of sections 15 and 20(a) complaints based on actual control would be such an unintended consequence.

IV. DEFENSES TO LIABILITY

A. Overview

The controlling person determination is, in a sense, a threshold issue. Even controlling persons are not liable if they can establish the

141 FILLEY, *supra* note 60, at 95.

142 See *supra* notes 124-25 and accompanying text.

143 FILLEY, *supra* note 60, at 92.

statutory defenses during the liability phase of a section 15 or 20(a) action.¹⁴⁴ The plaintiff should have the initial burden of showing that a defendant is a controlling person.¹⁴⁵ However, those determined to be controlling persons should have the burden of establishing the defenses of "no knowledge" and no "reasonable ground" to believe under section 15 or "good faith" and lack of "inducement" under section 20(a).¹⁴⁶

These defenses remain remarkably undefined. Can controlling persons satisfy the statutory defenses by showing that they did not "culpably participate" in the violations or may nonfeasance be a basis for liability?¹⁴⁷ Is it enough for controlling persons to show that they had no actual knowledge of Securities Acts violations for exculpation from liability under sections 15 and 20(a)? Can controlling persons escape liability by showing that their failure to control their controlled persons' violations was not intentional? Are the requirements for exculpation from liability the same under both controlling persons sections?¹⁴⁸ No consensus has developed with regard to the interpretation of sections 15 and 20(a) even with respect to such fundamental questions. Courts have approached the defense to liability phase of controlling persons actions differently and, not surprisingly, have achieved uneven results.

144 See *supra* note 9 and accompanying text.

145 See *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 897 (10th Cir. 1992), *rev'd sub nom. on other grounds*, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S.Ct. 1439 (1994) (stating that a plaintiff establishes "a prima facie case of controlling person liability 'when the . . . defendant [is] shown to be a controlling person'" (quoting *San Francisco-Okla. Petroleum Exploration Corp. v. Carston Oil Co.*, 765 F.2d 962, 964 (10th Cir. 1985)); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1572 (9th Cir. 1990) (same).

146 See *Donohoe v. Consolidated Operating & Prod. Corp.*, 30 F.3d 907, 912 (7th Cir. 1994) (holding that "the burden of proving good faith" is on the controlling person defendant); *First Interstate Bank of Denver N.A.*, 969 F.2d at 897 (same); *Carpenter v. Harris, Upham & Co., Inc.*, 594 F.2d 388, 394 (4th Cir. 1979) (same); see also *Arthur Children's Trust v. Keim*, 994 F.2d 1390, 1398 (9th Cir. 1993) (holding that a controlling person "has the burden of proving his absence of scienter").

147 See *supra* note 11 and accompanying text.

148 Many circuit courts have concluded that section 15 of the Securities Act and section 20(a) of the Exchange Act are to be interpreted the same, even as to the defenses thereunder. See, e.g., *Farley v. Henson*, 11 F.3d 827, 835 (8th Cir. 1993); *First Interstate Bank of Denver, N.A.*, 969 F.2d at 897; *Hollinger*, 914 F.2d at 1578; see also *Ferrara & Sanger*, *supra* note 6, at 1012. But see *infra* notes 186-88 and accompanying text.

B. Liability Under Section 15 of the Securities Act

1. Standard of Care

Initially, under section 15, controlling persons might have been held strictly liable, since as originally enacted, the provision did not expressly provide for any defenses to liability.¹⁴⁹ In the wake of criticism that this "insurer's" liability imposed by section 15 was too harsh a penalty for controlling persons, Congress in 1934 set about to provide a defense to liability under the section.¹⁵⁰ There was some sentiment to confine controlling person liability to cases involving intentional attempts to avoid liability. In this regard, an amendment to section 15 was offered that would have added to the then existing statutory language¹⁵¹ the following defense: "unless the act for which such controlled person is alleged to be liable under section 11 or 12 was not performed at the direction of the controlling person nor to enable such controlling person to evade liability under said sections."¹⁵² The author of the proposed amendment, Senator Fletcher, explained that it was intended "to restrict the scope of the section so as more accurately to carry out its real purpose. The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based."¹⁵³ Senator Fletcher's proposed amendment, with emphasis on intent, was not accepted by the conference committee.

As a result of the Congressional amendment, controlling persons are liable under section 15 of the Securities Act when they fail to prevent a violation of section 11 or section 12 of that Act unless "the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."¹⁵⁴ In light of this statutory language, the standard of care under section 15 should be *negligence*. This is the conclusion reached by the Supreme Court.¹⁵⁵ Controlling persons, then, should be liable under section 15 whenever they fail "to use such care as a reasonably prudent and careful person would use

149 See *supra* note 42 and accompanying text. I use "might have been" because, apparently, there were no cases decided under the section in the period between its adoption in 1933 and its amendment in 1934.

150 See *supra* notes 43-44 and accompanying text.

151 See *supra* note 4.

152 78 CONG. REC. 8668 (1934) (proposed amendment by Senator Fletcher).

153 *Id.* at 8669.

154 15 U.S.C. § 77o (1994).

155 See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976).

under similar circumstances"¹⁵⁶ to prevent a Securities Act violation¹⁵⁷ by their controlled person.¹⁵⁸ The negligence standard is an objective standard.¹⁵⁹ The defense of "no reasonable ground to believe" a controlled person was violating the Securities Act applies, even if the controlling person honestly believed there was no violative conduct. It can be observed that

[i]n negligence, the actor does not desire to bring about the consequences which follow, nor does he know that they are substantially certain to occur, or believe that they will. There is merely a risk of such consequences, sufficiently great to lead a reasonable person in his position to anticipate them, and to guard against them.¹⁶⁰

A negligence standard for section 15 is an appropriate standard, given that the focus of the Securities Act is on the affirmative requirement that those distributing securities provide offerees all material information concerning the offering.¹⁶¹ Such a standard serves the objective of fostering full disclosure, since it requires that controlling persons apply a relatively high degree of care to see that their controlled persons provide such disclosure. Further, the standard is consistent with the liability standards of sections 11 and 12.¹⁶²

2. General Defense Considerations

What should controlling person defendants in a section 15 action have to show to avoid liability? Controlling person defendants under section 15 must convince the court that their failure to prevent their

156 BLACK'S LAW DICTIONARY 1032 (6th ed. 1990).

157 Section 15 expressly refers to and is limited in its application to violations of sections 11 and 12 of the Securities Act. Frequently herein, reference is made to section 15's application to violations of the Securities Act without specifically referring to the two sections.

158 A person is negligent when he fails to do that "which a reasonable man . . . would do, or [does] something which a reasonable and prudent man would not do." BLACK'S LAW DICTIONARY 1032 (6th ed. 1990).

159 See KEETON ET AL., *supra* note 22, at 169.

160 *Id.*

161 Section 11—applicable to registration statements—and section 12(2)—applicable to offers of securities by means of a prospectus or oral communication—both create potential liability for untrue statements of material facts and omissions of material facts. See 15 U.S.C. §§ 77k, 771 (1994).

162 Under section 11, the issuer is strictly liable. Other section 11 defendants can escape liability, generally speaking, by establishing that they engaged in "reasonable investigation" and believed that the statements at issue were true. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Under section 12(2), defendants can avoid liability by showing that they exercised "reasonable care." See *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980).

controlled person's violation of section 11 or 12 occurred despite their reasonable—that is *nonnegligent*—conduct given all the facts and circumstances. The key considerations should revolve around whether the controlling person had culpable knowledge, or failed to perform a securities-related duty.

The section 15 defense expressly focuses on knowledge and, consequently, so should the tribunal. It seems clear that in order to avoid liability under section 15, controlling persons should have to convince the court¹⁶³ that they had no *actual knowledge of violations* of the Securities Act by their controlled person. Controlling persons unable to sustain this burden should be liable, unless they can demonstrate that they undertook a nonnegligent effort to prevent or end the violative conduct of their controlled person. Furthermore, section 15 literally requires that defenses to liability, thereunder, extend beyond the question of actual knowledge¹⁶⁴ of Securities Act violations. The section requires that a controlling person defendant not only show “no knowledge” to avoid liability, but “no reasonable ground to believe” that the controlled person was violating section 11 or 12 as well. Perhaps a formulation of the extension, true to the express statutory language and legislative history of section 15, would have the relevant knowledge extend to *knowledge of facts or circumstances suggestive of violations or the significant potential for violations* of the Securities Act. Without such an extension, controlling persons would be encouraged to “bury their heads in the sand” and ignore warnings of or situations rife for Securities Act violations so they could claim that they knew little or nothing about such violations by their controlled persons. Rather than promoting meaningful managing and monitoring of controlled persons, consistent with congressional intent, an actual knowledge requirement approach would have the opposite effect.

Consequently, if controlling persons do not possess actual knowledge of a Securities Act violation, additional questions should be addressed. The section 15 defense should be construed as compelling controlling persons to convince the tribunal that they knew of no *facts or circumstances that were suggestive of violations or the significant potential for violations* of the Securities Act by their controlled person. In that connection, a trier of fact should want to know whether controlling person defendants ignored or failed to follow up on any information or signs that there might be activities violative of the Securities Act being carried on by persons under their control. Further, a tribunal should want to know whether, in light of the nature of the controlling

163 See *supra* note 146 and accompanying text.

164 See *supra* note 4 and accompanying text.

person's association with the controlled person, the controlling person likely was apprised of a violation or potential violation of that Act. It would be appropriate for a court to attribute culpable knowledge to a controlling person when there is substantial evidence to support such an inference. Controlling persons with knowledge of suspicious facts or circumstances rife for Securities Act violations should be viewed as having culpable knowledge within the purview of section 15. However, in their defense, controlling persons should be allowed to show that they acted upon any potential for violations, for example, by probing or investigating possible violations, nonnegligently, to a reasonable (though with hindsight incorrect) conclusion of no violative conduct. Where the facts suggest a significant potential for Securities Act violations, the nonnegligent imposition of a mechanism reasonably designed to prevent or interdict such violations should allow for a successful defense under section 15 in some contexts.¹⁶⁵

3. Additional Defense Considerations for Controlling Persons with Duties Based on Their Authority to Control or Exercise of Actual Control

If controlling persons occupy a status, position, or role that requires them to manage or monitor their controlled person for Securities Act violations,¹⁶⁶ they should be required to show that they did perform such duties, nonnegligently, in order to successfully defend a section 15 claim.¹⁶⁷ Otherwise, knowing this function had not been performed adequately, controlling persons would have had reason to know of the potential for their controlled person's Securities Act viola-

165 *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576 (9th Cir. 1990) (holding that a broker-dealer can only establish good faith under a section 20(a) defense by proving that it "maintained and enforced a reasonable and proper system of supervision and internal control"); *Hunt v. Miller*, 908 F.2d 1210, 1215 (4th Cir. 1990) (holding that it was proper to ask the jury whether the corporation, if found to be a controlling person of its employee, "[took] adequate precautionary measures to prevent an injury caused by an employee, supervised its employees in an adequate and reasonable fashion, and maintained its system of control in a diligent manner").

166 These specific duties can be implied from the more general duties of persons authorized to manage and monitor. Compliance with statutes, regulations, and rules generally will be required of those authorized to manage or monitor a person. Governance norms for managers and monitors of enterprises encompass compliance with regulatory frameworks like the Securities Acts.

167 *See, e.g., Donohoe v. Consolidated Operating & Prod. Corp.*, 30 F.3d 907, 912 (7th Cir. 1994) (holding that a court should determine what the defendant controlling person could have done under the circumstances to prevent the violation, and then ask whether the controlling person—aware that he could take such measures—decided not to).

tion. Knowledge that the mechanisms and procedures designed to insure compliance with the Securities Act have not been fully employed should satisfy the culpable knowledge requirement of section 15. Under those circumstances a controlling person could not satisfy the requirement that he show "no reasonable ground to believe," in order to avoid liability under section 15.

Moreover, the express statutory language of section 15 provides a more general standard of conduct for controlling persons—negligence—which will not be met when controlling persons fail to apply due care with regard to a duty to manage or monitor their controlled persons for Securities Act violations. Due care should require that in the context of significant transactions involving securities distributions, controlling persons with monitoring and managing responsibilities have a reasonable basis for believing their controlled persons are complying with the Securities Act. Consequently, a duty analysis should be a part of the defense to liability calculus under section 15. Given that the identity of controlling persons and the roles played by them may vary greatly, the required showing for a successful defense should depend partially on their functions and duties under state law and how well they performed them.¹⁶⁸ Such an approach is consistent with the design of a Congress that pointedly underscored the idea that "[t]he duty of care to discover varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect."¹⁶⁹ Hence, the tribunal should determine if controlling persons have a duty to manage or monitor their controlled person, based either on their *authority to control* or their *exercise of actual control*. Regardless of the source, controlling persons should have to show that they satisfied that duty—nonnegligently—to avoid liability under section 15 for their controlled person's Securities Act violation. While controlling persons may reasonably rely on others, some control functions will be nondelegable. For example, a director or controlling person performing a similar function should perform certain monitoring duties in connection with significant disclosure documents. Such is the norm against which the conduct of any director should be measured. He will be expected to read such documents and satisfy himself that they contain all material information, correctly

168 Such an approach to the interpretation of the Securities Act has found acceptance in decisional law. For example, the Supreme Court has ruled that a person's duty to disclose material information in order to avoid liability under section 10(b) of the Exchange Act may depend in some circumstances on common-law principles. See *Chiarella v. United States*, 445 U.S. 222 (1980).

169 H.R. REP. NO. 73-85, at 9 (1933).

set forth.¹⁷⁰ This duty should be fulfilled nonnegligently if liability under section 15 is to be avoided.

In light of the foregoing considerations, controlling persons with substantial immersion in and responsibility for an enterprise's affairs should have difficulty showing that they "had no knowledge of . . . facts" about their controlled person's (i.e., the enterprise's) Securities Act violation. On the other hand, those not authorized to manage or monitor and not actually participating in any managing or monitoring function should have a relatively easier time establishing their section 15 defenses. They would not have to show they had no reason to suspect a violation by their controlled person arising out of their duties—in order to avoid liability—since they would have no relevant duties. Hence, just as in the case of controlling person determinations,¹⁷¹ the defense to liability phase of a section 15 proceeding can be approached somewhat differently depending upon whether defendants control on the basis of authority to control or actual control.

Persons determined to be controlling persons, based on their authority to control, should be considered to have the duties and responsibilities that inhere in their positions under generally accepted corporate governance norms for purposes of a section 15 defense analysis.¹⁷² Their defenses should be evaluated in light of these duties, which may include a duty to manage and/or monitor their controlled person's transactions and affairs¹⁷³ for compliance with the Securities Act. The incorporation of a duty analysis in an assessment of liability, of persons with authority to control, under section 15 is consistent with congressional purposes, and is necessary if a meaningful evaluation of defendants' adherence to the applicable standard of care is to be achieved. Congress' concerns with regard to controlling persons and Securities Act violations initially manifested itself in a proposed dummy director provision offered in the Senate.¹⁷⁴ Congress was concerned about default of responsibility by those authorized by law to control Securities Act violators.¹⁷⁵

On the other hand, persons with actual control will not have any duty to manage or monitor their controlled persons for Securities Act

170 See Larry W. Sonsini et al., *The Roles of the Parties in Preparing the Registration Statement*, A.L.I.-A.B.A. Course of Study (July 27, 1995).

171 See *supra* Parts III.C & III.D.

172 See *Dirks v. SEC*, 463 U.S. 646, 653-54 (1983) (discussing the relationship between insiders' fiduciary duties and the Exchange Act).

173 See *Fama & Jensen*, *supra* note 72, at 313.

174 See *supra* notes 36-39 and accompanying text.

175 See *supra* notes 36-39 and accompanying text.

violations, to avoid liability under section 15, unless they assume or usurp such functions. Something more than mere possession of the power to control is required before those with actual control have any duty to manage or monitor the conduct of their controlled persons under state law. The necessary additional ingredient is some evidence of *significant* participation in the affairs of the controlled person.¹⁷⁶ It is authority to control or significant *exercise* of actual control over a person that should create obligations to manage or monitor. When persons with actual control share or usurp the managing or monitoring functions of those with authority to control, they should be considered to have assumed the duties attendant to those functions.¹⁷⁷ This well-recognized approach under state law should be applied in the context of the controlling persons provisions. The incorporation of a duty analysis into the section 15 liability calculus for those with actual control who assume a duty vis-à-vis their controlled person seems appropriate, since the likely effect of a significant intrusion into the control functions of those with authority will be a breakdown of the normal protections against Securities Act violations that those with authority to control are supposed to provide. Having stepped into their shoes, persons exercising actual control should face potential liability under section 15 for nonfeasance in light of their assumption of the duties of those ordinarily granted authority to control.¹⁷⁸

When should a person who controls on the basis of actual control be considered to have assumed a duty to manage or monitor his controlled person for Securities Act violations? The factfinder should find that the person's intrusion into the organization's governance was so significant that the person shared or usurped the role of those with authority to control it.¹⁷⁹ Such a test is appropriate since it focuses the analysis on the degree of a defendant's potential involvement with and responsibility for the activity that is violative of the Securities Act. As far as the legislative intent can be gleaned, Congress sought, with section 15, to impose liability where there was or should have been substantial involvement in the policies and management of

176 See *Abbott v. Equity Group, Inc.*, 2 F.3d 613 (5th Cir. 1993); *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992); *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985).

177 See *A. Gay Jensen Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 291 (Minn. 1981) (holding that, under agency principles, assumption of control carries with it obligations of the controlled person).

178 *Id.* at 293-94.

179 In such circumstances, the elements necessary to establish a fiduciary duty under common law will be present. See Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539 (1949).

a Securities Act violator. There should be a distinction drawn between attenuated activities in or with the controlled person and significant participation in the management of that person. A finding of the latter circumstance should be a prerequisite for a finding of liability under section 15 based on a failure to manage or monitor. An approach that, in effect, would extend duties to manage or monitor to persons for remote or incidental involvement with a primary Securities Act violator is without support in the legislation or its history.¹⁸⁰

In summary, in the defense phase of a Section 15 proceeding, the court should focus on what would constitute reasonable conduct by controlling persons given the facts and circumstances they faced during the relevant period surrounding the Securities Act violation by their controlled person. In light of the role played by the controlling person, the context of the violations, and any other pertinent facts and circumstances in evidence, was the person's behavior regarding the controlled person's Securities Act violation negligent? Were the controlling person's actions and reactions within the range of ordinary prudence?¹⁸¹ After examining the record and drawing appropriate inferences therefrom, can it be concluded that the controlling person failed to anticipate and guard against an unreasonable risk of a Securities Act violation by his controlled person in a manner a reasonable person in his position would?¹⁸² If the answer to these questions is yes, a violation of section 15 of the Securities Act may well have been established.

C. Liability Under Section 20(a) of the Exchange Act

1. Standard of Care

Controlling persons will be liable for the violations of their controlled persons under section 20(a) unless they can demonstrate that they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."¹⁸³ Congress offered no explanation for the difference in the language used in sections 15 and 20(a) to set forth the controlling person defenses, even though the provision for a defense to liability in section 15 was added

180 There is no indication in the legislative history that persons other than those with a significant stake in or involvement with the controlled person should be subject to potential liability. See *supra* notes 67-68 and accompanying text.

181 See *supra* note 158.

182 See *supra* note 160.

183 15 U.S.C. § 78t(a) (1994).

as an amendment to the bill that adopted the Exchange Act.¹⁸⁴ Some courts have held that the liability calculus should be the same under both sections.¹⁸⁵ While controlling person determination may be identical under both provisions,¹⁸⁶ the same conclusion seems precluded with respect to defenses to liability. That is because, though it is generally accepted that a controlling person can be liable under section 15 although only negligent,¹⁸⁷ section 20(a) liability can be premised only on "a state-of-mind condition requiring something more than negligence."¹⁸⁸

The defense under section 20(a) should, in theory, provide a broader avenue of escape for controlling persons than the defense under section 15, since merely negligent conduct should not be a basis for liability. Perhaps the different language employed by Congress, and consequently the differing standards of care, may be explained by the fact that congressional focus in enacting the Securities Act (and hence sections 11, 12, and 15) was on distributions of securities,¹⁸⁹ whereas Congress's focus in enacting the Exchange Act (and hence section 20(a)) was on trading in issued securities.¹⁹⁰ The duties and liabilities imposed by sections 11 and 12 (and hence section 15) are reflective of the degree of care that should be taken by a relatively narrow class of persons¹⁹¹ involving a focused set of activities with respect to securities distributions or sales.¹⁹² The contexts in which section 20(a) may be invoked encompass a potentially wider range of

184 See Securities Act of 1934, ch. 404, sec. 209, § 15, 48 Stat. 881, 908 (1934) (codified as amended at 15 U.S.C. § 77o (1994)).

185 See *supra* note 148.

186 See *supra* note 53.

187 See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976).

188 *Id.* at 209 n.28.

189 See *Basile v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 551 F. Supp. 580, 582 (S.D. Ohio 1982).

190 *Id.* at 582-83.

191 Section 11 of the Securities Act creates potential liability for those who sign a registration statement, directors, experts (e.g., accountants) involved in the production of a registration statement, underwriters, etc. See 15 U.S.C. § 77k (1994). Section 12 creates liability for those who offer or sell securities either without a registration statement "in effect," or where securities are offered or sold by means of a materially misleading prospectus or oral communication. See *id.* § 77l. Compare *Pinter v. Dahl*, 486 U.S. 622, 650-54 (1988) (providing a narrow interpretation of who can be sued under section 12) with *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 154 (1976) (discussing the "broad universe of potential defendants subject to the prohibitions of [the Exchange] Act").

192 See HAMILTON, *supra* note 105, at 371 (discussing disclosure requirements and the "due diligence" investigation under the Securities Act).

transactions and practices, including purchases of securities.¹⁹³ Many Exchange Act prohibitions do not limit liability to a relatively narrow class of potential defendants. The universe of controlled persons under section 15 is defined and relatively limited compared to the universe of controlled persons under section 20(a). Further, Exchange Act prohibitions include acts that are generally manipulative “such as wash sales, matched orders, or rigged prices”¹⁹⁴—activities that may not be material to a firm. On the other hand, transactions that potentially implicate section 11 are almost always material to a firm and transactions that implicate section 12 frequently are material. Moreover, given the centrality of the disclosure of accurate information in distributions to confidence in the capital markets, a relatively high degree of care (lack of negligence) seems appropriate and consistent with that concern. Perhaps, in light of these considerations, a higher standard of conduct for controlling persons under section 15 than under section 20(a) is sensible.

How much more than negligence must be in evidence for liability under section 20(a)? Must there be evidence of intentional culpable participation in the violations or conscious disregard of actual knowledge of Exchange Act violations? Congress was silent on the appropriate standard of care under section 20(a) and no consensus on the question seems to have evolved through judicial interpretation.¹⁹⁵ Some courts have taken the position that culpable participation in Exchange Act violations is a prerequisite for liability under section 20(a).¹⁹⁶ To the extent these courts would limit liability to controlling-person defendants shown to have knowingly and actively participated in an Exchange Act violation, they are incorrect. The section literally does not require “culpable participation.” Bad faith can be shown by omission and the induce prong includes “indirect” inducement. Further, if participation was required, a person using strawmen, shell corporations, “dummies,” and other proxies could immunize themselves from liability much the way they did prior to the enactment of the controlling persons provisions. Such an outcome would contravene what Congress hoped to accomplish with section 20(a). So while section 20(a) clearly covers “culpable participation,” liability thereunder should not be limited to such situations. Liability

193 For example, section 10(b) of the Exchange Act makes it unlawful to employ “any manipulative or deceptive device or contrivance” not only in the sale but also in the purchase of securities. 15 U.S.C. § 78j(b) (1994).

194 *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

195 See *Donohoe v. Consolidated Operating & Prod. Corp.*, 30 F.3d 907, 912 (7th Cir. 1994); see also *supra* note 11.

196 See *supra* note 11.

under the section should be allowed for omissions to act as well as for acts of commission.

As for a standard of care for section 20(a), the next discrete level "up" the culpability scale that would constitute "a state-of-mind . . . requiring . . . more than negligence" would be *recklessness*. If reckless, "the actor has intentionally done an act [including omitting to act] of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences."¹⁹⁷ This is an appropriate standard against which to measure culpability under 20(a), given the allowed parameters. A more exacting standard clearly seems to be precluded by the express language of the statute and the Supreme Court's observations in *Ernst & Ernst v. Hochfelder*.¹⁹⁸ A less exacting standard seems not to be required by the statute and should not be adopted because it would be inimical to achieving the purposes of the provision.

In *Hochfelder*, the Supreme Court precluded negligent conduct as a basis for liability under section 10(b) of the Exchange Act just as it did with regard to section 20(a).¹⁹⁹ Since then, the standard of care issue has been addressed much more extensively in the context of cases brought under section 10(b), where heretofore, the federal courts have been virtually unanimous in holding that a showing of recklessness is sufficient to sustain liability thereunder.²⁰⁰ Reckless conduct has been defined in most of the 10(b) cases as conduct which is "highly unreasonable . . . [and which represents] an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."²⁰¹ The well-accepted recklessness standard under 10(b) would seem to be just as—if not more—compelling for section 20(a). It has been suggested that the Supreme Court might reject recklessness and require a show-

197 KEETON ET AL., *supra* note 22, at 213.

198 425 U.S. 185 (1976); see *supra* notes 187-88 and accompanying text.

199 425 U.S. 185, 193-215 (1976).

200 See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1572 (9th Cir. 1990); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Hackbart v. Holmes*, 675 F.2d 1114, 1117 (10th Cir. 1982); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544-45 (5th Cir. 1981); *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46-47 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1040 (7th Cir. 1977).

201 *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) (quoting *Franks v. Midwestern Okla. Dev. Auth.*, CCH Fed. Sec. L. Rep. ¶ 95,786, at 90,850 (W.D. Okla. 1976)).

ing of conscious intent to defraud as a prerequisite for liability under section 10(b).²⁰² However, application of a culpability standard under section 20(a) should not necessarily be confined to or constrained by considerations that might influence the interpretation of the appropriate standard for section 10(b).

The reasons for a recklessness standard in the context of section 20(a) arguably are more compelling. Section 20(a) does not contain the limiting language found in section 10(b); terms like "deceptive" and "manipulative" are absent from the text of section 20(a).²⁰³ While deceptive and manipulative use of controlled persons to violate the Exchange Act certainly is proscribed by section 20(a), its reach should be viewed as much broader, since the provision and such legislative history as exists proscribe failure to control without any other express qualification with respect to such failure. Perhaps the fact that private rights of action under section 10(b) are implied²⁰⁴ might influence the Supreme Court to reject a recklessness standard thereunder. However, it is important to focus upon the fact that by contrast, section 20(a) was specifically fashioned to provide monetary relief to private parties.²⁰⁵

A recklessness standard seems more appropriate for section 20(a) than a requirement of intentional wrongful participation or conscious disregard of actual knowledge. As has been observed with regard to the appropriate standard of care for section 10(b), "[t]o require in all type cases that a factfinder must find a specific intent to deceive or defraud would for all intents and purposes disembowel the private cause of action"²⁰⁶ This observation applies more compellingly with regard to section 20(a). Concern about evasion of responsibility and liability by persons with power was at the heart of congressional efforts manifested by the controlling persons provisions. Holding these persons responsible and liable had been difficult, if not impossible.²⁰⁷ Given their sophistication and power, few if any will ever be held accountable under section 20(a) if evidence of conscious intent

202 Section 10(b) of the Exchange Act makes it unlawful to employ "any manipulative or deceptive device or contrivance" in the purchase or sale of securities. 15 U.S.C. § 78j(b) (1994).

203 See 15 U.S.C. § 78t(a) (1994).

204 See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); see also *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) ("[A] private right of action under § 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure." (citations omitted)).

205 See 15 U.S.C. § 78t(a) (1994).

206 *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978).

207 See *supra* notes 20-34 and accompanying text.

to defraud is a prerequisite to their liability, in light of the subtleties sometimes involved in control. Such a result clearly would seem to be at odds with what Congress hoped to accomplish. A recklessness standard allows for a meaningful application of section 20(a) more consistent with congressional purposes than would intentional wrongful participation or conscious disregard of actual knowledge tests. Moreover, a recklessness standard is compatible with good faith—one prong of the defense standard expressly provided for by Congress in section 20(a).²⁰⁸ Good faith has been defined as “that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one’s duty or obligation.”²⁰⁹

Under section 20(a) the defense provided is two-fold—good faith *and non-inducement directly or indirectly*.²¹⁰ In light of the conjunctive structure of the statute, both elements of the defense should be established to avoid liability under section 20(a). The reason for the addition of the inducement element to the exculpatory test is far from clear. It might be suggested that the addition of this element to the good faith standard was superfluous since inducing Exchange Act violations seemingly would be the kind of purposive activity that would not be within the concept of good faith.²¹¹

Perhaps it is the “indirect” inducement prong of section 20(a) that is the significant addition. This prong of the defense may reflect congressional recognition of the fact that in the sometimes complex web of enterprise control, employee conduct will be determined by factors other than directives. Controlled persons operate in a framework and environment dominated by controlling persons. If their controlling persons reward them for accomplishing their securities-related missions without regard to whether they are accomplished dishonestly or ineptly, they are, in effect, issuing an indirect invitation to violative activity. Violations of the Exchange Act may be a consequence of a controlling person’s disregard for how their controlled persons perform their securities-related tasks. It seems clear that there is greater temptation and opportunity for Exchange Act violations where supervision is absent or slack. Therefore, failure to monitor securities matters and practices for compliance with the Exchange Act may indirectly induce violations of the Act. The inducement

208 See *supra* note 5.

209 BLACK’S LAW DICTIONARY 693 (6th ed. 1990).

210 See 15 U.S.C. § 78t(a) (1994).

211 “Induce” has been defined as “[t]o bring on or about, to affect, cause, to influence to an act or course of conduct, lead by persuasion or reasoning, incite by motives, prevail on.” BLACK’S LAW DICTIONARY 775 (6th ed. 1990).

prong—especially the indirect element—of section 20(a) may provide additional support for the notion that a successful defense thereunder should require more than a showing of lack of culpable participation or actual knowledge. A person could induce indirectly without crossing either of these two thresholds.

2. General Defense Considerations

What should controlling person defendants in section 20(a) actions have to show to avoid liability? They should have the burden of showing that their failure to prevent their controlled person's Exchange Act violation was not due to their conscious intent to allow the violation or their reckless indifference with regard to the possibility of a violation. While mere erroneous conduct and behavior alone, as measured against an objective standard, can subject a controlling person to liability under section 15, such conduct alone should not render one liable under section 20(a). "‘Good faith’ is inherently a subjective quality of the person acting or omitting to act rather than an objective description of the person's act or omission."²¹² Hence, there can be no liability under section 20(a) unless the tribunal concludes that the defendant's "state of mind" reflected "conscious indifference."

Section 20(a) defendants must convince the tribunal that they were free of bad faith and "inducing" conduct with respect to their controlled persons' Exchange Act violations. Where, contrary to their claims, controlling persons are shown to have intentionally facilitated a violation of the Exchange Act by their controlled persons, "bad faith" and "inducement" will preclude a successful defense. Cases of omission by controlling persons, generally speaking, are likely to be more difficult to resolve under section 20(a). In such circumstances, overt facilitation of violations may not be so much the focus as will the fact that defendants will not have prevented the Exchange Act violation by their controlled person. Where the issue is failure to act, controlling persons should have to show either that they had no relevant knowledge of the violation or that they responded within the appropriate standard of care, i.e., nonrecklessly.

Just as in the case of section 15, "knowledge" of the defendant should be a focus at the defense phase of a section 20(a) proceeding. If the tribunal is convinced that a controlling person had knowledge of their controlled person's violation of the Exchange Act, liability should follow unless some effort to prevent or interdict the violation is

²¹² Larry D. Soderquist, *The Proper Standard for Director's Negligence Liability*, 66 NOTRE DAME L. REV. 53 (1990).

shown. Consistent with the section 20(a) standard of care, such efforts must not have been reckless if liability is to be avoided. A controlling person clearly possessing actual knowledge of an Exchange Act violation by their controlled person would be liable even under a conscious intent standard. The more difficult challenge will be to determine when a controlling person should be liable where the evidence of actual knowledge is less than clear. Where there is evidence to support the conclusion that a controlling person "must have known" of *facts and circumstances strongly suggestive of a violation* of the Exchange Act by their controlled person, liability under section 20(a) could be affixed appropriately. Consequently, controlling persons should be required to convince the tribunal that they acted nonrecklessly in the wake of such facts and circumstances in order to avoid liability under the section.

3. Additional Defense Considerations for Controlling Persons with Duties Based on Their Authority to Control or Exercise of Actual Control

A duty analysis should be factored into cases brought under section 20(a). Since liability under the section can be premised on bad faith and indirect inducement, courts should be required to consider the degree of attention to duties assumed by controlling persons before exculpating them from section 20(a) liability. Where the facts and circumstances in evidence strongly support a conclusion that a violation eventuated because of a controlling person's failure to nonrecklessly perform a duty to manage or monitor their controlled person for Exchange Act violations, liability under section 20(a) may be appropriate. Under the aforementioned circumstances, a tribunal may well draw reasonable inferences that allow it to conclude that the controlling person's conduct reflected a reckless indifference to Exchange Act violations that established the "bad faith" required for liability under section 20(a). Where the dereliction of duty by a controlling person is shown to have been marked, it may well have reflected the reckless indifference that is a prerequisite to liability under the section.

Since the provisions were enacted to address the problem of default of responsibility by persons controlling those engaged in securities transactions,²¹³ it is appropriate that the liability calculus thereunder consider any such defaults. If in every case a person could avoid liability under section 20(a) merely by demonstrating the ab-

213 See *supra* Part III.

sence of culpable participation and a lack of actual knowledge of Exchange Act violations, the purposes of congressional enactment would be frustrated. Such a least common denominator gloss would reduce the potential potency of the controlling person provisions to the point of wondering why Congress bothered. Moreover, such an approach would scarcely accomplish much since any malfeasance, misfeasance, or nonfeasance thus covered likely would be a basis for primary liability.²¹⁴ If liability under section 20(a) could be premised only on culpable participation or actual knowledge, the less involved the controlling person was in the controlled person's activities, the easier it would be to establish a successful defense under section 20(a). Rather than being prompted to adhere to their fiduciary duties and provide meaningful monitoring of controlled persons to ensure compliance with the Exchange Act, controlling persons would be encouraged to be derelict with regard to their duties in order to remain ignorant of possible Exchange Act violations by their controlled persons. Not only would such an approach be at variance with the design of the Exchange Act, it could encourage controlling persons to violate their fiduciary duties under state law. Such a result cannot be the effect Congress sought with its enactment of section 20(a). Further, the role of the controlling person is important not only for the duty analysis. The role played can inform with respect to defendant's likely exposure to significant facts and circumstances bearing on the controlled person's violation.

Additionally, in actions under section 20(a), consideration should be given to whether a controlling person defendant had an economic incentive or motive that could have influenced his failure to restrain his controlled person. In light of the fact that "a state-of-mind condition requiring something more than negligence" must be in evidence in a contested section 20(a) action, the possible motives of a defendant may add significantly to the total mix of information from which the necessary inferences will be drawn. Where the economic incentives are considerable, the controlling person's conduct may be explicable by or reflective of his desire for the beneficial consequences of his controlled person's violation. Contrariwise, where any benefit would be nonexistent or de minimis, the section 20(a) defendant's good faith claim may be more compelling.²¹⁵

214 See Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALBANY L. REV. 637, 668-70 (1988) (discussing primary liability under the Exchange Act).

215 See, e.g., Jordan Eth & Michael Dicke, *Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious*, 1 STAN. J.L. BUS. & FIN. 97,

In summary, the court will have to determine whether the section 20(a) defense will be sustained based on analyses of the facts and circumstances in evidence including an evaluation of defendant's duties and incentives. While the test is to be a subjective one, objective norms will serve as referents against which defendant's conduct may be measured. The greater the deviation from the norms, the more justifiable will be a conclusion of conscious behavior or reckless indifference. Did the controlling person unreasonably act or fail to act in disregard of a known or obvious risk (that the controlled person would violate the Exchange Act) so great that it was highly probable that harm would follow? Did the controlling person's conduct indicate conscious indifference to the consequences?²¹⁶ If the answers to these questions are yes, a violation of section 20(a) may well have been established.

V. CONTROLLING PERSON LIABILITY: SOME EXAMPLES

A. *Controlling Person Liability Under Section 15*

1. Example One: A Controlling Shareholder

Assume that ZZ Corporation (ZZ), an issuer, is liable under section 11 of the Securities Act because its securities were sold pursuant to a misleading registration statement. Assume that T is sued under section 15 on the ground that he was a controlling person of ZZ, based on his control of a majority of the corporation's common shares.²¹⁷ Assume further that T offers no refutation of the assertion that he controlled a majority of the shares of ZZ during the period encompassing the section 11 violation. As a controlling person, T must carry his section 15 defense.²¹⁸ However, T was neither a director, officer, nor signer of the registration statement. T testifies that he exercised no corporate managing or monitoring role in ZZ. T testifies further that he had no part in preparing the registration statement, knew nothing of its contents, and in particular was ignorant of its false and misleading statements. Assume further that plaintiffs are unable to impeach T's testimony because the discovery process reveals no information that is contrary to his testimony. This would be highly likely where T has played no ratifying, managing, or monitoring role with regard to ZZ generally or to the subject distribution. Since the

105-06 (1994) (discussing economic incentive motive as a variable in determining defendants' scienter in cases brought under Rule 10b-5).

216 See *supra* note 197 and accompanying text.

217 See *supra* notes 97-100 and accompanying text.

218 See *supra* note 146 and accompanying text.

false statements in the misleading registration statement are the "facts by reason of which the liability of the controlled person [ZZ] is alleged to exist,"²¹⁹ and *T* credibly claimed ignorance of them, his defense should succeed. As a controlling person under no duty to manage or monitor, *T* should not be required to show that he took any affirmative action to assure himself that *ZZ's* offering complied with the Securities Act for a successful defense under section 15.²²⁰

2. Example Two: An Outside Director

Assume that *X* is an outside director of *AA Corporation* (*AA*), and that *AA* is being sued pursuant to section 12(1)²²¹ in connection with a securities offering that is material to the corporation. Assume further that *X* is being sued as a controlling person under section 15 on the ground that as a director of *AA* he was part of the controlling group,²²² the board of directors. *X* is unable to show that he somehow disassociated himself from the group or that a person other than the board of directors of *AA* controlled *AA* to the exclusion of the board.²²³ In these circumstances, *X* will have failed to rebut the presumption of his controlling person status.²²⁴ To avoid liability, if *AA* has violated section 12(1), *X* would have to show that despite the exercise of ordinary care, he did not know that *AA* was selling its securities through instrumentalities of interstate commerce in violation of section 5 of the Securities Act.²²⁵ If *X* is unable to show that he took appropriate action, nonnegligently, to have his controlled person comply with section 12(1), his defense should be unsuccessful. Because this is a transaction material to his firm, *X*, as a director, will have ratified the transaction.²²⁶ He should know that his company is selling its securities and that sales of securities must comply with applicable securities laws. He should know as well that corporate directors are expected to and relied upon under corporate governance norms to monitor their corporation's compliance with the Securities Act.²²⁷ Given these circumstances, an ordinarily prudent director would as-

219 15 U.S.C. § 77o (1994).

220 See *supra* note 167 and accompanying text.

221 15 U.S.C. § 77i(1) (1994) (providing for liability for persons offering or selling securities through instrumentalities of interstate commerce in violation of section 5 of the Securities Act (i.e., without a registration statement being "in effect")).

222 See 15 U.S.C. § 77o (1994).

223 See *supra* notes 114-15 and accompanying text.

224 See *supra* notes 114-15 and accompanying text.

225 See 15 U.S.C. § 77e (1994).

226 See *Sonsini et al.*, *supra* note 170, at 361-62.

227 *Id.*

sure himself within reason that his corporation is complying with section 5 of the Securities Act. The norm is for directors affirmatively to believe that their corporations are complying with the Securities Act's registration requirements in significant transactions. Knowing of the requirements, he should have a reasonable basis for believing that it is being complied with if he is to avoid liability under section 15 for his negligent failure to prevent his controlled person's violation of section 12(1) of the Securities Act. Only in those circumstances can he show "no reasonable ground to believe" a section 12(1) violation is being committed by his controlled person.

If X has acted with ordinary care, he should be able to defend himself successfully under section 15, notwithstanding AA's liability. For example, he might defend his conduct on the basis of having had a letter from reputable legal counsel opining that registration was not required because the offering was exempt from the requirements of registration.²²⁸ He might assert that he justifiably relied on counsel and that he had no reason to doubt the correctness of counsel's opinion. Under this scenario, X may very well have acted with the ordinary care necessary to avoid liability under section 15.

3. Example Three: A Creditor

Assume that Y, a bank, is the subject of an action under section 15 as a controlling person of BB Corporation (BB), a securities firm, being sued pursuant to section 12(2)²²⁹ of the Securities Act in connection with a securities offering. Assume that plaintiffs claim BB's sales of securities were pursuant to an offering circular that contained material misrepresentations and omissions in violation of section 12(2). Plaintiffs assert that Y was BB's sole creditor, that its extensions of credit provided a financial lifeline for BB,²³⁰ and that Y controlled the affairs of BB and failed to prevent BB's violations of section 12(2). Assume further that the evidence demonstrates that not only did Y have actual control of BB, the intrusion of Y into the corporate gov-

228 Directors are "entitled to rely on information, opinions, reports, or statements . . . prepared or presented by . . . legal counsel." REV. MODEL BUS. CORP. ACT § 8.30(b) (1984); see also DEL. CODE ANN. tit. 8, § 141(e) (1991) stating:

A member of the board of directors . . . shall, in the performance of his duties, be fully protected in relying in good faith upon . . . any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Id.

229 15 U.S.C. § 771(2) (1994).

230 See *infra* notes 360-62 and accompanying text.

ernance of the primary violator (*BB*) was so complete that *Y*, for all intents and purposes, supplanted the role of the board of directors.²³¹ The evidence shows that *Y* ratified *BB*'s major initiatives, including securities transactions, and monitored these transactions as well as all significant developments in *BB*.²³² To avoid liability under section 15 in these circumstances, *Y*, having usurped the role of *BB*'s board of directors, should have to show that it took appropriate action, with ordinary care, to insure that the circular was not false and misleading. For example, if *Y* could convince the tribunal that its agents carefully read the offering circular and reasonably believed that it contained all material information necessary for an informed investment decision, its defense may very well be successful. Such a showing would demonstrate to the tribunal the ordinary care required for exculpation from liability under section 15.²³³ The false statements in the circular are the "facts by reason of which the liability of the controlled person is alleged to exist,"²³⁴ and since *Y* had "no knowledge of or reasonable ground[s] to believe"²³⁵ that the statements were false, *Y*'s defense should be successful.

B. Controlling Person Liability Under Section 20(a)

1. Example Four (a): A Broker-Dealer Firm

Assume that *M*, an individual broker who claims to be an independent contractor,²³⁶ has violated Exchange Act section 10(b)²³⁷ and Rule 10b-5²³⁸ thereunder by churning the account of *O*. As it turns out, *M* is impecunious. Assume that, pursuant to section 20(a), *O* sues *V*, the corporate broker-dealer that *M* was affiliated with at the time of the churning. *O* maintains that *V* controlled *M* by clothing him with the imprimatur of the firm and providing him with the necessary instrumentalities that enabled him to ply his trade and that *V* failed to stop the violative conduct or employ a compliance program reasonably designed to prevent churning.²³⁹ If *V* is unable to refute

231 See *supra* notes 176-78 and accompanying text.

232 See *supra* notes 176-78 and accompanying text.

233 See 15 U.S.C. § 77o (1994).

234 *Id.*

235 *Id.*

236 See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1573-74 (9th Cir. 1990) (en banc) (discussing controlling person liability for Exchange Act violations of independent contractors).

237 15 U.S.C. § 78j(b) (1994).

238 17 C.F.R. § 240.10b-5 (1994).

239 See *supra* note 165 and accompanying text.

these allegations, all the preconditions for liability will have been established. Broker-dealer firms exercise or should exercise a great deal of control over the conditions of their operations and their individual brokers whether employees or "independent contractors."²⁴⁰ Further, a failure to establish a compliance program by a broker-dealer firm likely will fall into the category of reckless behavior.²⁴¹ It will be clear to the tribunal that controlling person brokerage firms frequently benefit from the churning practices of their controlled persons. Such firms should know that by lax supervision of their controlled persons they indirectly condone and induce Exchange Act violations.²⁴² These considerations should make a successful defense by *V* difficult to sustain.

2. Example Four (b): A Person Controlling a Broker-Dealer Firm

Suppose we change the previous example by assuming that *V* successfully refutes the claim that it controlled *M* by showing that *E*, a forty-percent shareholder of *V*, chairman of its board of directors, and its chief executive officer, in fact controlled *V* to the exclusion of all other persons and exercised complete dominion over *V*, including its affiliations with independent contractors. Assume that, in light of these developments, *O* amends his complaint by dropping *V* and adding *E* as the controlling person defendant. *E* would have the same burden for exculpation that *V* had in Four (a) to show that his failure to interdict the Exchange Act violation by *M* was not due to recklessness. In this context, given *E*'s knowledge base and duties, his failure to have *V* employ a compliance program reasonably designed to interdict churning likely will be judged reckless and a basis for liability under section 20(a).²⁴³

240 See Alexander C. Dill, *Broker-Dealer Regulation Under the Securities Exchange Act of 1934: The Case of Independent Contracting*, 1994 COLUM. BUS. L. REV. 189.

241 *Id.*; *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438 (N.D. Cal. 1968), modified, 430 F.2d 1202 (9th Cir. 1970). In *Hecht*, the Ninth Circuit stated:

[F]ailure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed, not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it.

Id.; see also *SEC v. First Sec. Co.*, 463 F.2d 981, 987 (7th Cir. 1972) (stating that "good faith" under section 20(a) requires affirmative acts on the part of the controlling person to prevent the misconduct of the controlled person).

242 See *supra* text accompanying notes 211-12.

243 See *supra* note 240 and accompanying text.

3. Example Five: A Controlling Officer

Assume that *G* is the President of *DD* Corporation (*DD*) that is being sued pursuant to section 10(b) and Rule 10b-5 promulgated thereunder in connection with a securities offering that is material to the corporation. Plaintiffs claim that *DD* has sold an offering pursuant to a circular containing material misrepresentations and omissions. Assume further that *G* is being sued as a controlling person under section 20(a). *G* was the chief operating officer of *DD*—his title was not merely honorary²⁴⁴—and he is unable to refute the allegation that he was a controlling person by, for example, showing that other persons controlled *DD* to his exclusion.²⁴⁵ Though there was an independent board of directors of *DD*, *G* had all the authority to control necessary to dominate the securities disclosure practices of *DD*.²⁴⁶ In these circumstances, *G* should be unable to avoid controlling person status. To avoid liability under section 20(a) if *DD* has violated 10b-5, *G* should have to show that he acted nonrecklessly to insure that the circular was not false and misleading. Under the circumstances, given his knowledge base, proximity to relevant events, and duties, he might well have a difficult time demonstrating that his effort or lack thereof to insure that *DD*'s circular fully disclosed all material information was not reckless.²⁴⁷

4. Example Six: An Outside Director

Assume that *FF* Corporation (*FF*), a publicly held corporation, has violated section 14 of the Exchange Act²⁴⁸ because its proxy statement contained false and misleading statements of a material nature. Assume that *J* is sued pursuant to section 20(a), plaintiff having alleged that *J* was a controlling person based on his membership on the board of directors of *FF*. *J* offers no effective refutation of the assertion that he was a controlling person of *FF* in light of his board membership. *J* testifies that he voted to approve the proxy statement after having read it carefully. Assume, however, that the evidence reveals that had *J* read the proxy statement at all, the false and misleading disclosure would have been quite evident to him in light of his knowledge of the corporation's affairs. A director's section 20(a) defense should encompass the requirement that he show that he conscientiously reviewed significant documents generated by the company's

244 See *supra* note 114 and accompanying text.

245 See *supra* note 114 and accompanying text.

246 See *supra* note 76 and accompanying text.

247 See *supra* Parts IV.C.2-3.

248 15 U.S.C. § 78n (1994) (regulating proxy solicitation).

executive officers, in connection with major transactions, prior to ratifying their actions.²⁴⁹ In these circumstances, the fact that *J* either consciously intended to allow his controlled person's violation or was reckless in ratifying, though not reading, the proxy statement should preclude a successful good faith, noninducement defense by *J*. Such a failure would be conduct which is "highly unreasonable . . . [and which represents] an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."²⁵⁰

VI. SOME IMPLICATIONS OF THE CONTROLLING PERSONS PROVISIONS FOR VARIOUS PERSONS

A. Corporations

1. Control

Corporations are the legal owners of their assets that are deployed in connection with various of the organization's endeavors conducted by its agents. As a principal, a corporation can, under law, command its agents within the agency.²⁵¹ A corporation would be a controlling person under sections 15 and 20(a) on the basis of its *authority to control* company personnel and employees who are the causal agents of Securities Acts violations occurring within the agency.²⁵² However, it could avoid liability under the sections if it established the defenses thereunder. On the other hand, at common law, an enterprise is absolutely liable for the tortious acts of its agents committed within the agency—there is no defense to liability.²⁵³ If these common-law principles apply with respect to Securities Acts violations, sections 15 and 20(a) likely would not be relied upon by plaintiffs in many actions under the Securities Acts, since liability under those sections is not absolute—there are defenses.²⁵⁴

249 See Sonsini et al., *supra* note 170, at 359-60.

250 *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) (quoting *Franks v. Midwestern Okla. Dev. Auth.*, CCH Fed. Sec. L. Rep. ¶ 95,786, at 90,850 (W.D. Okla. 1976)); see *supra* note 201 and accompanying text.

251 See *supra* note 90 and accompanying text.

252 See *supra* notes 62-64, 90 and accompanying text.

253 *Ferrara & Sanger*, *supra* note 6, at 1016; RESTATEMENT (SECOND) OF AGENCY §§ 212-13 (1958).

254 At one time, the circuits were split over whether the existence of sections 15 and 20(a) forecloses principals' vicarious liability for the primary Securities Acts violations of their agents (such as employees). See *Ferrara & Sanger*, *supra* note 6, at 1015-22. Over time, however, a consensus built in favor of the notion that the existence of

When a corporation's agent acts outside of the agency, controlling person status for the organization under sections 15 and 20(a), vis-à-vis that agent, is not necessarily precluded. While a corporation will not have *authority to control* an agent with regard to the Securities Acts violations committed outside of the agency, the corporation may nonetheless be a controlling person since it may have the power (*actual control*) to force the employee to cease the violative conduct.²⁵⁵ Indeed, when a Securities Acts violation is committed by an employee outside the agency, a controlling person action may be the only route to holding the corporation liable. Moreover, regardless of whether common law principal-agent liability principles apply to Securities Acts violations, counsel can be expected, in some cases, to plead both theories to cover the possibility that a court will determine that the violations occurred outside of the agency.

An enterprise may control another organization and, indirectly, that organization's agents and employees. An enterprise's section 15 or 20(a) control of another organization may arise from virtually any source on which any other controlling person's status can be based. For example, a corporation may be a controlling person when it owns the majority of the shares of another corporation on the basis of its authority to control (legal control) the subsidiary.²⁵⁶ In this context, it is the status as a majority shareholder that is significant for controlling person analyses. Similarly, a corporate creditor may have actual control of another person in light of the power over the person provided by its leverage as a creditor.²⁵⁷

the controlling persons provisions does *not* preclude principals' vicarious liability under the Securities Acts. See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990). The Third Circuit has held that the contrary notion should prevail in some circumstances. *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 180-84 (3d Cir. 1981); *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 884-86 (3d Cir. 1975). However, it has been suggested that the Supreme Court's decision in *Central Bank of Denver* may indicate that the Court would not accept liability under the Securities Acts on any basis not expressly provided for by Congress, including vicarious liability. See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1460 n.12 (1994) (Stevens, J., dissenting) ("[M]any courts, concluding that § 20(a)'s 'controlling person' provisions are not the exclusive source of secondary liability under the Exchange Act, have imposed liability in § 10(b) actions based upon *respondereat superior* and other common-law agency principles. These decisions . . . appear unlikely to survive the Court's decision." (citations omitted)).

255 See *supra* notes 123-25 and accompanying text.

256 See *supra* notes 97-100 and accompanying text.

257 See *supra* note 130 and accompanying text.

2. Liability

Just as a corporation's controlling person status under sections 15 and 20(a) should be measured by the same criteria as any other person's, so too should its liability. For example, if a corporation is a controlling person on the basis of being the majority shareholder of another enterprise, its liability should be measured in the same way as that of any other controlling shareholder.²⁵⁸ By the same token, a controlling person corporation, through the acts of its agents, may intrude sufficiently in the ratification, management, and monitoring functions of another person so as to acquire executive officer or director-type exculpation from liability burdens under sections 15 and 20(a).²⁵⁹

3. A Word About Broker-Dealer Corporations

In light of the inherent and substantial possibility that their agents and independent contractors associated with them will violate the Securities Acts, broker-dealer firms should be held to relatively stringent standards and a rigorous, exacting burden vis-à-vis the statutory defenses under sections 15 and 20(a).²⁶⁰ Such firms are expected to, and thus should, exercise a substantial degree of discipline and control over "their" brokers, whether employees or independent contractors.²⁶¹ Industry standards require the implementation of programs designed to prevent securities fraud in the brokerage business arena. A broker-dealer firm's failure to demonstrate that it met industry standards with regard to preventive programs may make it virtually impossible to claim, successfully, the statutory defenses under either section 15 or section 20(a), since such a failure likely will be viewed as not only negligent but reckless as well.²⁶²

B. Shareholders (Including Corporate Parents)

1. Control

In a sense, ultimate control of corporate organizations reposes in shareholders. Though the business and affairs of the corporation are to be managed by or under the authority of its board of directors,²⁶³

258 See *supra* Part V.B.2.

259 See *supra* Parts IV.B.2 and IV.C.2.

260 See *Hollinger*, 914 F.2d at 1575.

261 See *Dill*, *supra* note 240 at 222.

262 See *supra* note 165 and accompanying text.

263 DEL. CODE ANN. tit. 8, § 141(a) (1991) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of

those directors are elected²⁶⁴ and may be removed²⁶⁵ by the shareholders. Further, decisions about organizational structure ultimately are made by shareholders who must ratify them.²⁶⁶ Given these important ratifying and monitoring functions, shareholders may be controlling persons where their joint, collective action is sufficient to determine the outcome of directorial elections or structural changes. When a majority of the outstanding voting shares of a corporation is owned by a person or by an affiliated group of shareholders, a form of legally enforceable control (*authority*) within the purview of sections 15 and 20(a) is present.²⁶⁷ Shareholdings also may provide a basis for concluding that a person or group is a controlling person of a corporation, on the basis of *actual control*, even though the quantum controlled is less than an absolute majority of the voting stock,²⁶⁸ so long as it is sufficient virtually to insure the outcome of directorial elections and removals.²⁶⁹ Though in theory direction over the activities of a corporation is exercised principally by or through the board of directors, controlling shareholders have the power to select the board and

a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); REV. MODEL BUS. CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32."); ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 cmt. f (stating that "ultimate responsibility for approving major corporate plans and actions is vested in the board").

264 DEL. CODE ANN. tit. 8, § 216(3) (1991) ("Directors shall be elected by a plurality of the votes of the shares . . ."); REV. MODEL BUS. CORP. ACT § 8.03(d) (1984) ("Directors are elected at the first annual shareholders' meeting and at each annual meeting thereafter unless their terms are staggered under section 8.06").

265 DEL. CODE ANN. tit. 8, § 141(k) (1991) ("Any director of the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares . . ."); REV. MODEL BUS. CORP. ACT § 8.08(a) (1984) ("The shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause.").

266 See *supra* note 100 and accompanying text.

267 See *supra* notes 97-100 and accompanying text; ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.10(a) (defining controlling shareholder as a person who owns or has the power to vote fifty percent of the corporation's shares).

268 See *supra* notes 126-28 and accompanying text; ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.10(b) (providing for a presumption of controlling influence where there is ownership and/or possession of the power to vote more than twenty-five percent of the corporation's shares).

269 See *supra* notes 126-27 and accompanying text.

they can and frequently do exert pressure on directorial decisionmaking that may be dispositive.²⁷⁰

Where plaintiffs seek to establish shareholder controlling person status, they should be required to allege with sufficient particularity that the person or group commanded control of a majority of the shares of the enterprise or of a quantum sufficient to control the election of directors. Such an allegation should suffice to support a conclusion of controlling person status on the basis of possession of authority to control (control of majority of shares) or actual control (of a sufficient quantum of shares), unless evidence disproving the claim is offered.²⁷¹ If defendants are unable to refute plaintiffs' claim of control based on shareholdings, the burden should shift to the controlling shareholder or shareholders to sustain their statutory defenses.²⁷²

However, where any shareholder is "grouped"²⁷³ with the controlling shareholders, a definitive act of disassociation should be allowed as a basis for excluding such a person from the group. A written declaration to the other shareholders in the controlling person group by such a shareholder of his belief that a particular act or course of conduct (that subsequently becomes a basis for a lawsuit) may be violative of the Securities Acts would be such a definitive act.²⁷⁴ Disassociation from the group should be negated if the shareholder subsequently voted for or took any other action that advanced the Securities Acts violation.

2. Liability

Shareholders have certain matters referred to them by law for approval, such as the election of directors and fundamental changes in corporate structure.²⁷⁵ In addition, controlling shareholders may confer with directors and executive officers about a range of corpo-

270 ALI takes the position that a person is a controlling shareholder "if the person exercises a controlling influence over management or policies of the corporation or the transaction or conduct in question by virtue of the person's position as a shareholder." ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.10 cmt.

271 ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.10 cmt. ("The presumption [that an individual with 25 percent ownership controls the corporation] is rebuttable, and may be rebutted by facts establishing that the 25 percent shareholder does not in fact exercise control over the management or policies of the corporation.").

272 See *supra* note 146 and accompanying text.

273 See *supra* note 77 and accompanying text.

274 This course of action would be similar to that allowed directors. See *infra* note 311 and accompanying text.

275 See *supra* note 266 and accompanying text.

rate matters from the selection of officers to various corporate policy and operational matters. If, in the course of their association with their corporation, controlling shareholders obtain knowledge of Securities Acts violations by their controlled person—the enterprise—they should be liable under sections 15 and 20(a) if they cannot satisfy the applicable test for exculpation.²⁷⁶ Controlling shareholders should be required to establish that no Securities Acts violations were brought to their attention, nor did they learn of any through their association with their corporation.²⁷⁷ If compelling evidence shows that controlling shareholders came into the possession of actual knowledge of Securities Acts violations by their controlled persons, they should have to show nonnegligent (section 15) or nonreckless (section 20(a)) efforts to prevent or end such violations to avoid liability.²⁷⁸ For example, controlling shareholders might show that they importuned the board of directors to correct their corporation's Securities Acts violations, under the threat of removal and actual removal if necessary. Consistent with the purposes of sections 15 and 20(a), controlling persons, even if "mere" shareholders, should not be allowed to benefit where they have knowledge of Securities Acts violations and fail to act to interdict them.

However, other than in the aforementioned situations, controlling shareholders should not be liable under sections 15 and 20(a) for the Securities Acts violations of their enterprises and its personnel solely because of their shareholdings. There should be no duty to *manage* or *monitor* the corporation's affairs or scrutinize transactions for Securities Acts violations for shareholders *qua* shareholders and hence no liability, under sections 15 or 20(a), for failure to do so even when they control a majority of the shares. Controlling shareholders should be able to remain essentially passive and rely on their corporation's directors and executive officers to monitor and manage its securities-related business and affairs without being concerned with potential liability under the controlling persons provisions. Moreover, even when controlling shareholders choose to be active and consult with directors and officers and monitor their performance; they should not inherit the duties of directors and officers unless they usurp or share the management and monitoring functions that directors and officers perform *for the corporation*. Controlling shareholders should be allowed to participate in corporate affairs for their own purposes without inheriting corporate duties, as long as such participa-

276 See *supra* Parts IV.B-C.

277 See *supra* Parts IV.B-C.

278 See *supra* Parts IV.B-C.

tion is not dominating in nature²⁷⁹ and those authorized to perform management and monitoring functions for the corporation are not merely "dummies" doing the controlling shareholders' bidding. Such a scenario might arise when shareholdings or groupings of shareholdings result in a controlling shareholder or shareholder group with only actual control (i.e., control of less than the absolute majority of shares that would give them legal control or authority to control) under sections 15 or 20(a).

This approach to shareholder responsibility and liability under sections 15 and 20(a) respects the separation of ownership and management as a fundamental purpose of the corporate form of organization.²⁸⁰ To require controlling shareholders to manage or monitor the corporation's securities matters for compliance with the Securities Acts, and hence to second guess directors and officers, would not be sensible since such tasks will be beyond the capacity²⁸¹ or interests²⁸²

279 See *supra* notes 217-20 and accompanying text.

280 Separation has been declared "a major reason for the success of the modern corporate form as a business entity." ECONOMIC REPORT OF THE PRESIDENT 188 (1985).

281 See generally J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 Wake Forest L. Rev. 9 (1987). But see Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1990) (arguing that as sophisticated institutional investors begin to accumulate concentrated stock holdings there is potential for more effective collective action by stockholders).

282 Under what is commonly known as the "Wall Street Rule," shareholders dissatisfied with a company's management sell their shares rather than get involved in efforts to effect change within the organization. As Lyman Johnson writes:

[A]lthough shareholders possess suffrage under corporate statutes and may remove derelict directors, recourse to this mechanism often proves futile because coordinating large numbers of shareholders into effective collective action is colossally problematic and because management ordinarily dominates the proxy machinery. As a result, most disenchanted shareholders dispose of their stock on capital markets rather than pursue internal governance remedies of doubtful efficacy.

Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 900 (1990) (footnote omitted). J.A. Livingston described this phenomenon succinctly:

This right to sell stock—to vote for or against a management in the market place—is different from a vote at a stockholder's meeting. When a stockholder votes against a slate of directors, he is exercising his right as a stockholder, as an owner. He hopes to change the management and improve the company. But a stockholder who sells says to hell with it. He is not going to reform the company. He is not an owner trying to increase the value of his property. He says, in effect, "Include me out."

J.A. LIVINGSTON, *THE AMERICAN STOCKHOLDER* 61 (1958). This predisposition is not believed to be as prevalent today as it was two decades ago. See Bernard S. Black,

of many of those shareholders. Moreover, a system of broader responsibility and liability would complicate capital formation in certain contexts.²⁸³ Those desirous of being passive investors or only minimally involved in corporate affairs would want to avoid all potential control situations in order to avoid acquiring the duties, responsibilities, and liabilities of sections 15 and 20(a). Consequently, they would keep their stake in any one corporation smaller than might otherwise be the case.

Further, controlling shareholders, generally speaking, do not have affirmative duties under state law to manage and monitor their corporations as directors and officers have.²⁸⁴ There is no warrant for believing that sections 15 and 20(a) were meant to change the fundamental relationship that allows shareholders essentially to be passive investors without the fear of liability arising from corporate transactions and operations. In enacting the controlling persons provisions, Congress seems to have been primarily concerned about passive officers and directors, not passive shareholders. There is no evidence or reason to believe that Congress wished to affect the traditional right of shareholders to remain passive in organizations that have functioning (as opposed to "dummy") officers and directors.

However, where controlling shareholders do not confine themselves to normal incidents of ownership, their sections 15 and 20(a) liability possibilities should increase. Controlling shareholders' active participation in the governance of their enterprises may be so intrusive that they essentially share or usurp the management and monitoring functions that the board of directors or executive officers ordinarily exercise.²⁸⁵ Defendant controlling shareholders should have to convince the tribunal that any exercise of shareholder rights did not cross the participation threshold that would render the person a de facto director or officer. If controlling shareholders fail to make such a showing, it is appropriate that they be held to the same standards of conduct that apply to controlling persons who are outside directors or executive officers and that they be required to

Shareholder Passivity Reexamined, 89 MICH. L. REV. 520, 572-73 (1990) (arguing that large institutional investors are becoming reluctant to use this "exit" alternative because their portfolios are too large to be absorbed by the market).

283 See generally Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

284 Corporate statutes specify no managing or monitoring functions for shareholders *qua* shareholders. Corporate statutes prescribe such duties for officers and directors. See generally DEL. CODE ANN. tit. 8, § 141-45 (1991); REV. MODEL BUS. CORP. ACT §§ 8.01-8.63 (1984).

285 See *supra* notes 176-79 and accompanying text.

mount similar defenses to exculpate themselves from liability under sections 15 and 20(a).²⁸⁶ When controlling shareholders have authority to control (control of a majority of the shares), a conclusion that they share or usurp management and monitoring functions of their controlled person should be more difficult to avoid if there is participation in the governance of the controlled person beyond the normal incidents of ownership, such as voting and making informational inquiries.

3. A Word About Institutional Investors

It has been suggested that participation by institutional investors in corporate governance can have a salutary effect by providing a needed restraint on executive officers' predisposition to entrenchment and excessive agency costs.²⁸⁷ It is contended, however, that this potential likely will not be realized, in part because institutional investors are unwilling to take collective action for fear of liability under

286 See *supra* notes 176-79 and accompanying text. Where shareholders usurp directors they are exercising actual control because their shareholder *qua* shareholder status would not provide authority to usurp board functions. Of course, in the closely held corporation context, if the appropriate prerequisites were satisfied, they would have authority. See REV. MODEL BUS. CORP. ACT § 8.01(a) (1984) ("Except as provided in section 7.32, each corporation must have a board of directors." (emphasis added)); *id.* § 7.32(a)(1) ("An agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it eliminates the board of directors . . ."). When shareholders are authorized to assume directorial powers and functions, they also assume directorial liabilities. See REV. MODEL BUS. CORP. ACT § 7.32(e) (1984), stating that:

An agreement authorized by this section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.

Id.

287 Black, *supra* note 282, at 521-24; Rock, *supra* note 281, at 448-49. Rock argues:

When the fifty largest institutions control a majority of the stock, it would seem likely or inevitable that they would be able to organize themselves to minimize agency costs, that is, the costs of the separation of ownership and control. Now, at last, it would seem that an alternative to the independent outside director might emerge. In contrast to the independent outside director—who . . . is at best independent of both shareholders and management and often has no individual economic stake in effectively disciplining management—the institutional investor would seem to have both the incentive and the abilities to constrain management.

Id. (footnote omitted).

sections 15 and 20(a).²⁸⁸ Advocates of a greater voice for institutional investors have suggested that the controlling person liability rules muffle the voices of institutional investors because of the rules' "overbreadth."²⁸⁹ I believe that these concerns are overstated, especially if the courts' approach to institutional investors under sections 15 and 20(a) is similar to that suggested herein.

When institutional investors act in concert as shareholders, they indeed may be a controlling person group within the purview of sections 15 and 20(a).²⁹⁰ However, establishing controlling person status for institutional investors likely will prove difficult for plaintiffs in many instances. Plaintiffs will have the burden of showing that institutional investors had the requisite quantity of collective holdings that enabled them to choose or remove directors and that they acted in concert.²⁹¹ If the controlled shareholdings are less than a majority, plaintiffs will have to establish all the preconditions necessary for determining actual control based on shareholdings.²⁹² Moreover, where their combined shareholdings are less than a majority, institutional investors well might argue against a controlling person determination on the ground that their combined efforts resulted in the exertion of mere influence, not control.²⁹³

Furthermore, even if institutional investors are deemed to be controlling persons, their liability risks should ordinarily not be substantial. If their participation in corporate affairs was limited, even if active, they merely need to show their limited participation and lack of any knowledge of Securities Acts violations for exculpation from liability under sections 15 and 20(a).²⁹⁴ Their defense need not include evidence of managing and monitoring for Securities Acts violations unless their direct participation in the affairs of the portfolio company was so substantial that they in effect shared or usurped the organization's management or monitoring functions.²⁹⁵

288 See Black, *supra* note 282, at 548.

289 *Id.* at 548-49.

290 See *supra* notes 77-80 and accompanying text; ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.09 (defining controlling group as any group that "act[s] in concert to exercise a controlling influence over the management or policies of the business organization"). The ALI employs "controlling influence" in its *Principles of Corporate Governance* much the way "control" is employed herein. It is clearly distinct from "mere" influence because it is backed by some form of power.

291 See *supra* notes 77-80 and accompanying text.

292 See *supra* notes 126-28 and accompanying text.

293 See *supra* notes 81-84 and accompanying text.

294 See *supra* Parts IV.B & C.

295 See *supra* notes 176-80 and accompanying text.

C. *Outside Directors and Persons Performing Similar Functions*

1. Control

In light of their broad grant of authority, directors are controlling persons of their organizations, since they have some responsibility for all that the corporation and its agents do.²⁹⁶ Hence, no matter how remote the violation, directors should be presumed to be controlling persons when a Securities Acts violation has been committed by their corporation and its agents, unless they convince the tribunal that other persons controlled to their exclusion.²⁹⁷ Such a conclusion is warranted by the fact that control within the meaning of sections 15 and 20(a) does not require the direct exercise of control over the primary defendants. Rather, all that is necessary is the power to at least indirectly control the primary offenders. Considerations such as practical ability to control should be addressed during the defense phase of a section 15 or 20(a) action.²⁹⁸ Of course, a directorate is a collegial body, so that individual directors may not be able to command enterprise personnel to cease or desist from violating the Securities Acts. However, all directors can be considered to be part of a controlling person group—the board.²⁹⁹

Some have suggested that while in theory directors control the affairs of an enterprise, in reality they are not in a position to exert meaningful control in many corporations.³⁰⁰ It is contended that they do not have the time or access to information that would enable them to exert effective control over the management of corporate affairs.³⁰¹ It is pointed out that directors are often bound to executive officers

296 See *supra* notes 101-05 and accompanying text; ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 (broadly defining the responsibilities of the board of directors).

297 See *supra* notes 114-15 and accompanying text.

298 See *supra* note 118 and accompanying text.

299 See *supra* notes 77-79 and accompanying text.

300 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 cmt. i ("Although board exercise of [management] power would be extremely unusual in a publicly held corporation, it might occur . . ."); WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 288-89 (7th ed. 1995); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481 (1984); Cary and Eisenberg argue that

the typical board could not possibly 'manage' the business of a large, publicly held corporation in the normal sense of that term: such businesses are far too complex to be managed by persons who put in the equivalent of five to ten working days a year In a complex organization concerned with complex choices, policy cannot be developed on a part-time basis.

CARY & EISENBERG, *supra* at 290-91.

301 Manning, *supra* note 300, at 1481-92.

through friendships, the "old-boy-network," and other informal means. Further, it is maintained that there is a structural bias inherent in directorships that predisposes a softness towards executive malfeasance, misfeasance, and nonfeasance.³⁰² Hence, it is maintained that outside directors do little more than rubber stamp decisions of executive officers.³⁰³ In sum, it is argued that outside directors realistically cannot or should not be expected to be effective monitors of their organization's personnel and activities. Anyone accepting this viewpoint might be predisposed to reject the idea that an outside director should be presumed to be a controlling person within the purview of sections 15 and 20(a). In fact, some courts have precluded controlling person liability on the ground that the defendant was an "inactive" outside director.³⁰⁴

There is no warrant for subscribing to this least common denominator view of directors. Because the law commands that the affairs of corporations be managed by or under the direction of a board of directors,³⁰⁵ it is appropriate to presume they have at least indirect control over all corporate affairs and personnel. There, however, are realistic limitations on the capacity of directors to prevent Securities Acts violations that legitimately may be taken into consideration in actions against them under sections 15 and 20(a). Obviously, not all corporate activities with possible Securities Acts ramifications will be significant enough to command the attention of outside directors. Directors cannot review every aspect of an enterprise's operations; they cannot be expected to consider and ratify every decision or to have detailed knowledge about all corporate activities that implicate the Se-

302 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 1.34 cmt. b (focusing, because of the "informal" influence that executives may exert over board members, on "relationships that may be expected to inhibit the objectivity of [board] review, not simply on relationships with the corporation"); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, 85.

303 Myles L. Mace, *The President and the Board of Directors*, HARV. BUS. REV., Mar.-Apr. 1972, at 37, 39; Alan R. Parmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1357-58 (1989) ("Studies of the actual dynamics of modern corporate governance indicate that management—the corporation's senior executive officers—actually operates the business and generally controls the information, advice, and alternatives available to the board. The public corporation's board serves largely as a 'rubber stamp' for management initiatives . . ." (footnotes omitted)).

304 See, e.g., *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981) ("There must be some showing of actual participation in the corporation's operation or some influence before the consequences of control may be imposed.").

305 See *supra* note 27.

curities Acts. The greater the size and scope of an enterprise's operations, the more this is true.³⁰⁶

Nonetheless, there is reason for presuming all directors to be controlling persons under sections 15 and 20(a). The fact that directors are concerned with ratifying major initiatives and monitoring management performance is beside the point. A decision by the board of directors ordering the corporation's legal counsel to design and implement a systematic legal compliance or audit program to deal with operational-level securities concerns would be a broad policy initiative with a significant monitoring component as well. Such a course of action may in fact be indicated where there is a pattern of Securities Acts violations in these operational-level matters. In such a situation, it might be appropriate to hold directors accountable, under section 15 or 20(a), for their derogation of duty in failing to adopt a plan or course of action designed to end the Securities Acts violations by their controlled persons.

A justifiable lack of knowledge of Securities Acts violations by directors should allow for a successful defense to any liability under sections 15³⁰⁷ and 20(a).³⁰⁸ However, a lack of knowledge, no matter how justifiable, should not negate controlling person status; the knowledge question should be addressed in the liability phase.³⁰⁹ It is at that phase in a controlling person action that the myriad of possible justifications for failure to prevent Securities Acts violations should be considered. As previously discussed, all directors as a board comprise a controlling group.³¹⁰ However, individual board members should be able to separate themselves from that group with respect to a particular matter by appropriate objection. A recorded objection by any director to the course of conduct violative of the Securities Acts should be allowed to rebut a presumption of controlling person status; such an objection should serve to separate the director from the controlling group.³¹¹

306 ROBERT CHARLES CLARK, *CORPORATE LAW* 108-09 (1986). Professor Clark points out that the Model Business Corporation Act was amended in 1974. Whereas the Act had provided that "the business and affairs of a corporation shall be *managed* by a board of directors," it was changed to read "managed *under the direction* of a board of directors." *Id.* at 108 (emphases added). According to Professor Clark, "[t]he idea was to preclude any possibility—no realistic possibility existed—that the section might be interpreted to require active involvement by boards in day-to-day affairs of corporations." *Id.*

307 *See supra* Part IV.B.

308 *See supra* Part IV.C.

309 *See supra* notes 144-46 and accompanying text.

310 *See supra* notes 77-78 and accompanying text.

311 *See* REV. MODEL BUS. CORP. ACT § 8.24(d) (1984):

2. Liability

a. Significant Transactions

Generally speaking, outside directors are entitled to rely heavily on the corporation's executive officers with respect to the management of ordinary operations of the business.³¹² More direct attention and involvement, however, is expected of outside directors with respect to substantial corporate transactions such as public offerings, acquisitions, mergers, and consolidations.³¹³ Issuances of stock in the aforementioned types of transactions will require disclosure of full and accurate information in accordance with the requirements of the Securities Acts.³¹⁴ Voting on such major transactions or related recommendations³¹⁵ and monitoring for full disclosure³¹⁶ in connection

A director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is deemed to have assented to the action taken unless: (1) he objects at the beginning of the meeting (or promptly upon his arrival) to holding it or transacting business at the meeting; (2) his dissent or abstention from the action taken is entered in the minutes of the meeting; or (3) he delivers written notice of his dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

Id.

312 See Hamilton, *supra* note 106, at 9-12.

313 See Sonsini et al., *supra* note 170, at 359-61.

314 CLARK, *supra* note 306, at 105-06.

315 See LEWIS D. SOLOMON ET AL., CORPORATIONS, LAW AND POLICY: MATERIALS AND PROBLEMS 673-74 (3d ed. 1994) observing:

[D]irector's conduct may be viewed along a continuum. At one end, directors perform their monitoring function When monitoring, directors may or may not be making discrete decisions At the other end of the spectrum, directors clearly engage in specific decision-making: to build a new plant, raise capital for a new project, acquire another corporation.

Id. See also REV. MODEL BUS. CORP. ACT § 11.03(a) (1984) ("After adopting a plan of merger or share exchange, the board of directors of each corporation party to the merger, and the board of directors of the corporation whose shares will be acquired in the share exchange, shall submit the plan of merger or share exchange for approval of shareholders."); *supra* note 100.

316 Section 11's so-called due diligence defense may require directors to make reasonable inquiries with respect to the accuracy of the registration statements. See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

Section 12 imposes a duty of *reasonable care* on sellers and offerors of securities to ascertain the accuracy of prospectuses. Directors bear primary responsibility for fulfilling this duty on behalf of their corporations. The reasonable care standard may require reasonable inquiries depending on the circumstances of the case. See, e.g.,

therewith are not duties that are wholly delegable by directors.³¹⁷ Because they must ratify such transactions,³¹⁸ outside directors will be on notice that the corporation is undertaking important endeavors with significant Securities Acts implications. They are, or should be, aware that under the circumstances, they will be expected to make some effort to monitor such transactions for compliance with the Securities Acts.³¹⁹ Thus, while broad delegations of authority are the order of the day in corporate organizations,³²⁰ some participation in the disclosure process in major transactions should be considered to be part of the duties of outside directors.³²¹ Unlike the shareholder *qua* shareholder, outside directors cannot divorce themselves from any role in major transactions and assume that there will be full compliance with the Securities Acts.

Any evaluation of an outside director's section 15 or section 20(a) liability should consider whether, in connection with significant transactions, he ratified and monitored the disclosure process to assure himself that all material information was being given to potential purchasers of the firm's securities.³²² Ignorance of the fact that purchasers actually were being misled should not suffice as a defense to liability under sections 15 and 20(a) for an outside director.³²³ He

Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980). See also SOLOMON, *supra* note 315, at 673.

317 ALI, CORPORATE GOVERNANCE, *supra* note 71, § 3.02 cmt. j ("Although the board can (and normally will) delegate to committees the performance of parts of the oversight function . . . the board must maintain a continuing presence in and ultimate responsibility for the overall performance of that function.").

318 See *supra* note 315 and accompanying text.

319 Sonsini et al., *supra* note 170, at 361-62.

320 As Robert Hamilton explains,

[s]everal largely independent internal hierarchical structures may exist within the lower levels of the corporate bureaucracy, each culminating in a single person or, in rare instances, a small committee that has responsibility for one or more areas or operations. A person may be 'President of the Plastics Division' or 'Head of the Chemicals Sector' of a large corporation with responsibility for the profitability of a multi-plant business with sales of billions of dollars per year and yet be several hierarchical levels below the highest management level within the corporation itself.

Hamilton, *supra* note 106, at 9 (footnote omitted).

321 JAMES HAMILTON, ET AL., RESPONSIBILITIES OF CORPORATE OFFICERS AND DIRECTORS UNDER FEDERAL SECURITIES LAWS 17 (1996); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1183-90 (1977).

322 HAMILTON, *supra* note 321, at 17.

323 See, e.g., *supra* notes 249-50. Essentially, the analysis and evaluation should be applied in the context of other significant transactions requiring disclosure such as those within the Exchange Act's proxy rules.

should be required to convince the tribunal that having monitored the disclosure process and the company's agents directly managing it, he affirmatively believed that his company's securities were being sold on the basis of full disclosure of all material information.³²⁴ Only in that case could he conclude that his duties were being discharged properly. Even then, the controlling persons provisions should be construed as requiring that where such belief turns out to have been mistaken; such a mistake must not have been the product of negligence (section 15)³²⁵ or recklessness (section 20(a)),³²⁶ if the outside director is to escape liability.

With respect to particular significant corporate transactions that implicate the Securities Acts, outside directors could show that they have not been negligent or reckless by showing that they attended the relevant meetings, scrutinized the relevant documents, and thoroughly satisfied themselves that all relevant material information was accurately and fully disclosed to the transacting parties, shareholders, and the public.³²⁷ Of course, where there is a troublesome situation or the revelation of disturbing facts, outside directors should follow up to a conclusion that no Securities Acts violations are present before permitting the transaction to proceed.³²⁸

Important factors bearing upon an outside director's culpability and liability under sections 15 and 20(a) should include his involvement in the preparation of any documents, his sophistication, expertise, and access to information, his involvement with the controlled person (in addition to the directorship),³²⁹ any procedures adopted to prevent deficiencies,³³⁰ and the reasonableness of his reliance upon management and its advisers in preparing relevant disclosure documents.³³¹ An individual outside director should obtain exculpation from liability if he clearly expresses his objections to the subject trans-

324 See, e.g., *supra* notes 249-50.

325 See *supra* Part IV.B.1.

326 See *supra* Part IV.C.1. The Revised Model Business Corporation Act requires a director to discharge his duties "with the care . . . an ordinarily prudent person in a like position would exercise under similar circumstances." REV. MODEL BUS. CORP. ACT § 8.30(a)(2) (1984).

327 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 4.02 cmt. c (relating that, in general, a director or officer must read or otherwise become familiar with information, an opinion, a report, a statement, a decision, or a judgment to be entitled to rely on it); Sonsini et al., *supra* note 170, at 361-62.

328 See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

329 HAMILTON, *supra* note 321, at 30.

330 See *supra* note 165 and accompanying text.

331 See *supra* note 228 and accompanying text.

action on the grounds of potential Securities Acts violations and votes against the transaction and otherwise does nothing to advance it.³³²

b. Ordinary Operations

Outside directors, generally speaking, cannot be expected to do the kind of ratifying and monitoring of general corporate affairs that they should exercise with respect to significant transactions. Consequently, the requirements for exculpation from liability, under sections 15 and 20(a), that should be imposed upon the outside director in the context of significant securities transactions should not necessarily be extended to ordinary corporate affairs with a securities nexus. Securities Acts violations may occur in a context not directly related to any specific transaction that is material to the firm. Other than in the context of extraordinary matters like material transactions, outside directors should be able to assume that the executive officers are managing the corporation's affairs in compliance with the mandates of law, including the Securities Acts, unless there is reason to suspect otherwise.³³³ Without the focus of mandated disclosure in the context of significant transactions, there is, generally speaking, no automatic course of conduct which should be required of outside directors as a prerequisite for exculpation from sections 15 and 20(a) liability. Of course, if outside directors become apprised of Securities Acts violations uncorrected by executive officers, they should take appropriate action. Outside directors should be expected to act reasonably in light of the circumstances.³³⁴

D. Executive Officers, Managers, and Persons Performing Similar Functions

1. Control

Under general corporate governance norms, management—the implementation of the corporate policies ratified by the directors—is

332 See *supra* note 311 and accompanying text.

333 See, e.g., *Graham*, 188 A.2d at 130 (“[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”).

334 See REV. MODEL BUS. CORP. ACT § 8.30(a)(2) (1984). See also Soderquist, *supra* note 212, at 52 (arguing that the liability of directors should be determined through a “good faith standard . . . that relates to the conduct itself rather than to the results of the conduct”).

primarily the responsibility of executive officers.³³⁵ Their authority is set by statute, bylaws, and resolutions as well as custom and practice.³³⁶ A corporation's chief executive officer ordinarily has managerial responsibility and authority over enterprise practices, personnel, and policy implementation.³³⁷ However, all executive officers with firm-wide authority should be presumed to be controlling persons of all the organization's affairs and personnel under their domain.³³⁸ For example, an enterprise's chief executive for corporate finance ordinarily is authorized to oversee the drafting of a registration statement and normally would be responsible for its contents.³³⁹ He could overrule the work-product contributions of those making inputs, order that certain techniques be employed, and order the changing of specific information offered. In light of his authority over the registration statement preparation activities, he would be a controlling person within the purview of sections 15 and 20(a).³⁴⁰ Of course, a single management position alone may not create sufficient authority to prevent or end a Securities Acts violation. In many companies, a number of officers and managers may be grouped as controlling persons, since they function together in the implementation of key decisions.³⁴¹ In larger corporations, group action may in fact be the dominant way by which executive management functions in many organizational contexts.³⁴²

In larger enterprises, with respect to important functions not centralized on a firm-wide basis, there will still be reviewing and deciding

335 ALI, *CORPORATE GOVERNANCE*, *supra* note 71, § 3.01 (charging corporate officers with the responsibility of the corporation's management); CARY & EISENBERG, *supra* note 300, at 287 ("In recent times, it has become obvious that the traditional legal model is inadequate. Under that model, the board of directors manages the corporation's business and sets business policy. . . . All serious students of corporate affairs . . . now recognize that in the typical large publicly held corporation the management function is vested not in the board but in the executives.").

336 CARY & EISENBERG, *supra* note 300, at 299-302.

337 SOLOMON, *supra* note 315, at 379 ("The officer with the greatest authority—the senior officer in any given corporation—generally is designated the chief executive officer or CEO."); *id.* at 380-81 ("Since some corporeal person must carry on the corporation's business, courts assume that the CEO, whether known as the president or by some other title, has authority to bind the corporation in transactions entered into in the ordinary course of business.").

338 *See supra* note 106 and accompanying text.

339 Sonsini et al., *supra* note 170, at 359-60.

340 *See supra* notes 106-07 and accompanying text.

341 *See supra* note 79 and accompanying text; ALI, *CORPORATE GOVERNANCE*, *supra* note 71, § 3.01 cmt. c (recognizing that the management function may be exercised by a group of senior executives).

342 *See supra* note 79 and accompanying text.

functions performed by some person or group responsible for management. Divisions, headed by the equivalent of a chief executive officer, frequently possess full operational authority over certain functions.³⁴³ The potential controlling person liability of divisional executive level officials should not be precluded, in light of the fact that larger corporations have allocated the burden of much of the operational decision making away from the firm-wide executive management cadre by decentralization.³⁴⁴ Any such preclusion might insulate those with authority to control from responsibility for Securities Acts violations solely due to the peculiarities of organizational structure. Divisional officers with executive authority should be presumed to have the control to prevent Securities Acts violations by those under their authority, in the same way as corporate officers with firm-wide authority.³⁴⁵

With respect to determining whether an officer is a controlling person within the meaning of sections 15 and 20(a), the inquiry should focus on whether the official was authorized to perform important executive duties of such character that he likely would have been able to prevent or direct the cessation of the subject Securities Acts violations with a relative degree of finality. If this inquiry can be answered in the affirmative, we should presume that the subject executive officer is a controlling person.

One potential concern with presuming that officers are controlling persons arises from the fact that the duties of particular officers may vary from enterprise to enterprise. Each corporation will have its own system of internal organization, and not all will have the same set of duties for each officer with a particular title. For example, in most corporations, the president is the active managing head with wide-ranging authority.³⁴⁶ On the other hand, in some corporations, the president may have limited authority. He may only preside at meetings, perform advisory roles, or conduct ceremonial duties. Notwithstanding the possible lack of commonality in the roles officers play, an orthodox approach stressing the "typical" features in corporate orga-

343 See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 20-22 (1990) (discussing the organization and decisionmaking of large firms).

344 See Hamilton, *supra* note 106, at 9 ("Many corporations today are so large and are involved in so many diverse lines of business that business decision-making is diversified and diffused.").

345 *Id.* at 11.

346 See generally CARY & EISENBERG, *supra* note 300, at 237 (explaining that some cases hold that when the president of a corporation also serves as its general manager, he has implied authority to execute any contract appropriate in the ordinary course of business).

nizations should be taken. The organizational structure of individual companies should be ignored, at least initially. For example, it should be presumed that all presidents have, by virtue of their office, the authority of a general manager for purposes of sections 15 and 20(a). Such a presumption, however, should be rebuttable. Corporate "presidents" should have the opportunity to prove that no authority existed for them to act as general manager.³⁴⁷ All titled officers should have the burden of proving that, despite titles that ordinarily confer authority over certain Securities Acts violators, they in fact did not possess such authority.

It is important to consider that officers, in theory and frequently in fact, serve at the will of "higher ups." Management power may be viewed as delegated authority, since officers may be overruled by other officers with superior authority or by the board of directors. Moreover, even if they are not overruled, it fairly well may be implied that officers may be susceptible to and compliant with the will of higher-level officers, the board of directors, or even shareholders. Nevertheless, an executive officer should not be allowed to avoid controlling person status on the theory that he could or would have been overruled or that he felt organizational pressures to refrain from taking steps to end activities violative of the Securities Acts. An officer's controlling person status should not be affected by the fact that there was a person or group with the authority to overrule hovering in the background, unless the officer can convince the tribunal that some other person or persons had control to the exclusion of the officer. If officers can show that in fact they were overruled, then an exercise of such latent power in the matter at issue should take the officer off the controlling person hook. Perhaps to take into consideration the aforementioned pressures and other realities of organizational life, an officer presenting evidence that he clearly presented information, in writing, about possible Securities Acts violations to officers of superior authority or the board of directors should be severed from sections 15 or 20(a) actions. Consistent with the approach advocated herein, the presumption of control based on authority should in no way impede individual officers from avoiding liability where legally sufficient defenses are offered.³⁴⁸

2. Liability

An appropriate starting place for considering the liability of officers will be most of the considerations discussed previously in con-

347 See *supra* note 114 and accompanying text.

348 See *supra* note 118 and accompanying text.

nection with the liability of outside directors.³⁴⁹ Ordinarily, the chief executive officer of an enterprise should have to sustain at least as compelling a defense as an outside director with regard to both extraordinary transactions and ordinary operations.³⁵⁰ However, it is well recognized that whatever the standard of care may be, there may be important variables that produce different outcomes for various enterprise personnel in judicial proceedings to determine officer or director liability.³⁵¹ The greater one's involvement in the business and operations of the corporation, the higher will be the expectations with respect to performance.³⁵² Unlike outside directors who, generally speaking, perform only ratification and monitoring functions³⁵³ on a part-time basis, executive officers perform full-time active monitoring and management functions for their enterprise.³⁵⁴ Ordinarily, they have somewhat broader and more extensive duties than outside directors with respect to enterprise operations and practices, including those involving securities-related matters.

These differences between functions performed and access provided may make officers liable in situations in which outside directors would not be.³⁵⁵ Executive officers have continuing access to information on which to base judgments concerning securities disclosure.³⁵⁶ Their access may mean that officers in fact know or should know more about a corporation's activities and learn more about the corporation in the course of ordinary business activities than do outside directors. Moreover, the abilities of other executives and personnel may be revealed to executive officers through personal observation, meetings, and reports, thus increasing their ability to determine their competence and reliability. Under sections 15 and 20(a), officers should be

349 See *supra* notes 312-32 and accompanying text.

350 See *supra* notes 312-32 and accompanying text.

351 See generally *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682-99 (S.D.N.Y. 1968).

352 *Id.*

353 See Hamilton, *supra* note 106, at 7.

354 See SOLOMON, *supra* note 315, at 32 ("Although the corporation statute and the bylaws impose few specific duties, the officers constitute the management of the corporation and are responsible for running its business day-to-day."); see also ALI CORPORATE GOVERNANCE, *supra* note 71, § 4.02 cmt. i (observing that "officers will generally have a greater obligation than outside directors to be familiar with the affairs of a corporation").

355 HAMILTON, *supra* note 321, ¶ 304 ("[L]iability is more apt to be imposed upon directors who are doubling as officers or who are involved in the management of the company's routine business. Outside directors . . . may be insulated from liability, depending on the nature of their involvement.").

356 *Id.*

responsible and liable because of the knowledge that fairly may be attributed to them in light of their organizational activities and exposure.³⁵⁷ Given the nature and extent of officers' involvement with and dominion over organizational affairs, sections 15 and 20(a) should be interpreted as requiring a relatively compelling defense on the part of executive officers who claim inability to prevent Securities Acts violations by their controlled persons.

Generally speaking, the determination of culpability of officers will depend on so many variables that specific guidelines cannot hope to do more than provide a base from which the analysis of specific situations can be conducted. In this regard, important factors may include his involvement in the preparation of any documents; his sophistication, expertise, and access to information; his corporate position; any procedures adopted to prevent Securities Acts violations; and the reasonableness of his reliance upon collateral professionals and other officers and personnel.³⁵⁸ An individual officer's defense under sections 15 and 20(a) should be satisfied if he clearly expresses, to superior officers or the board of directors, his objections to a subject transaction or course of securities-related conduct on the grounds of potential Securities Acts violations.³⁵⁹

E. Creditors

1. Control

Creditors of an enterprise may be controlling persons within the purview of sections 15 and 20(a) on the basis of their actual control of the enterprise's business and personnel.³⁶⁰ Power to control may exist by virtue of being a significant source of financing, perhaps even the sole source. Under such circumstances, it is hard to ignore the conclusion that the creditor has considerable power over its debtor. This

357 See ALI, CORPORATE GOVERNANCE, *supra* note 71, § 4.02 cmt. f (recognizing that officers have special experience and technical skills upon which others might rely).

358 See generally, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682-99 (S.D.N.Y. 1968).

359 These factors are essentially the same ones that should be taken into account when assessing director liability. See *supra* note 311 and accompanying text.

360 See *In re Falstaff Brewing Corp. Antitrust Litig.*, 441 F. Supp. 62, 68 (E.D. Mo. 1978) (holding that allegations that lender defendants controlled the daily affairs of the corporation were sufficient to state a cause of action under section 20(a); the debtor alleged that the lender required the debtor to replace acting officers and directors, revise its debt structure, implement certain policies, give additional security, and obtain approval before acquiring or selling capital assets); David R. Cordell, Comment, *Lender Liability for Securities Law Violations of Its Borrowers*, 38 OKLA. L. REV. 113, 118 (1985).

power may be manifested, in part, by a formal agreement granting the right to control specific matters or granting some more general dominion over enterprise business and affairs. For example, covenants may provide lenders with the right to declare a default on a loan in a variety of circumstances, such as changes in management, mergers, or sales of substantial assets. Covenants in loan agreements restricting such matters as future indebtedness, payment of dividends, or lines of business are fairly common. Creditors may even dictate management decisions concerning matters such as which creditors will be paid and when payment will be made, whom the debtor will retain and hire, which assets will be held and which sold, and which contracts will be accepted.³⁶¹

In addition to powers over a borrower's affairs expressly granted by contract, creditors may have additional clout that is latent, but nonetheless potentially effective as a constraint. The control wielded may include consulting on a range of corporate practices and policies not expressly provided for in any agreement. The mere threat of withholding credit if the advice and signals sent during such "consultations" are not adhered to may be tantamount to a form of dominion that equals control, even if not pursuant to any express agreement. In other words, the tacit understanding that financing will continue to be provided so long as its source is pleased is a form of actual control a financier may possess.³⁶²

Having explored several facets of control in the debtor-creditor context, what implications can we draw about when a creditor is a controlling person within the meaning of sections 15 and 20(a)? In order to establish controlling person status for a creditor, it should be necessary first to show that such a creditor would have been able to direct the management, policies, or personnel of its debtor in a way likely to avoid or end the conduct violative of the Securities Acts.³⁶³ Ability to control can be demonstrated by reference to powers granted

361 See generally Douglas-Hamilton, *supra* note 137.

362 See Douglas-Hamilton, *supra* note 137.

363 As David Cordell observes:

Conduct actionable under the securities laws for which lending institutions have been held liable has assumed many forms. However, restricting discussion to cases where lenders have been attacked as parties to securities violations by virtue of their lender-borrower relationships with the primary violators, the case law is incomplete as to exactly what conduct will render a lender responsible under the securities laws. Not surprising, the cases tend to depend heavily upon their facts. The degree to which the lender was involved with its borrower has been the determinative factor in the assessment of . . . controlling person . . . liability.

Cordell, *supra* note 360, at 127.

by the contract or to a quite significant debtor-creditor relationship. A plaintiff should not be required to allege that the creditor actually exercised some control over the borrower if he makes a credible claim that the lender possessed the power to control the debtor and the specific transaction or activity upon which the primary violation of the Securities Acts is predicated.³⁶⁴ However, if a creditor defendant convinces the tribunal that there was no exercise of actual control, the presumption of control based on power will have been successfully rebutted.³⁶⁵

2. Liability

If creditors *qua* creditors, deemed to be controlling persons, have knowledge of Securities Acts violations, they should have a duty under sections 15 and 20(a) to direct their cessation and should be liable when they cannot show their reasonable efforts to end the violations by their controlled person.³⁶⁶ For example, a letter to the board expressing the creditor's concerns about possible Securities Acts violations might suffice to satisfy the creditor's obligations under sections 15 and 20(a) where the creditor makes clear that he will take the steps necessary to end his provision of credit. Creditor controlling persons should have no duty under sections 15 and 20(a) other than to react to Securities Acts violations known to them, unless they have assumed a role within the debtor that obligates them to.³⁶⁷

If a creditor assumes such control over a debtor's business affairs that existing centers of authority are supplanted or joined, the creditor would have become, in effect, the *de facto* board of directors or chief executive officer.³⁶⁸ When creditors usurp the control of those responsible for the corporation's ratification, management, and monitoring functions (directors and officers), their liability under sections 15 and 20(a) should be measured by the same standard.³⁶⁹ Their usurpation will establish their capacity for controlling monitoring or management functions, as well as their exercise of and responsibility for such functions.

364 See *supra* text accompanying notes 142-43.

365 See *supra* text accompanying note 140-41.

366 See *supra* Parts IV.B-C.

367 See *supra* Parts IV.B-C.

368 See *supra* notes 176-80 & 229-35 and accompanying text.

369 See *supra* notes 176-80 & 229-35 and accompanying text. See also Joseph W. Bartlett & Philip S. Lapatin, *The Status of a Creditor as a 'Controlling Person'*, 28 MERCER L. REV. 639 (1977) (arguing that lenders may be liable as a controlling person if they use their favorable bargaining position to take part in the profits of their debtor rather than merely secure the repayment of an already existent debt).

However, there are compelling reasons why creditors should be allowed considerable leeway to work with their debtors without undue fear of being liable as a controlling person. Involvement by a controlling person creditor in their debtor's affairs may facilitate the ability of the debtor to generate the additional revenue necessary to satisfy the subject debt obligation, as well as meet other important obligations. Creditors should be encouraged to work with a debtor's business to protect their debt rather than be discouraged from doing so because of an overly broad interpretation of sections 15 and 20(a) that would have the effect of forcing creditors to seek "early" involuntary liquidation or bankruptcy. Put another way, significantly heightening creditors' responsibility and potential liability under the Securities Acts could tend to spur foreclosures and discourage creditors from undertaking loan workouts, with resulting defaults and insolvencies that might otherwise be avoided. Creditors should be able to provide counseling and advice to their debtors as well as insist upon a course of conduct by their debtor that is consistent with the debt obligation without undue concern with sections 15 and 20(a). If that were not the case, long recognized and well established lending practices could result in responsibilities and liabilities under the Securities Acts. It is unlikely that Congress intended such a result with the passage of sections 15 and 20(a). Moreover, any such effect likely would manifest itself in lesser involvement by creditors in their debtors' affairs in order to decrease the risks of liability under the Securities Acts.³⁷⁰ Alternatively, the price of credit would increase to compensate for the increase in risk.³⁷¹

In light of these considerations, courts should require a strong showing that a creditor exercised such actual, participatory dominion over the debtor that it assumed or usurped the roles ordinarily performed by directors or officers. If controlling person creditors can convince the tribunal that they played a lesser role in their debtor's

³⁷⁰ See *Metge v. Baehler*, 577 F. Supp. 810, 818 (S.D. Iowa 1984), *rev'd in part, aff'd in part*, 762 F.2d 621 (1985). In *Metge*, the court observed:

Most commercial loan agreements also give the lender the right to exercise certain powers over the borrower corporation in the event of default or upon the occurrence of other specified events. If the mere *possession* of such power and influence over a borrower were enough to impose on the lender the burden of proving its own good faith and non-inducement in the event of a securities law violation by the borrower, the heightened potential for liability would deter lenders from making loans to corporations involved in securities transactions.

Id.

³⁷¹ See generally Douglas-Hamilton, *supra* note 137.

affairs, they should be able to obtain exculpation under sections 15 and 20(a) without having to show that they monitored or managed the debtor to prevent Securities Acts violations.³⁷²

On the other hand, the threat of liability under sections 15 and 20(a) should prod creditors to take into account their control role before deciding when and how to exercise it in the context of securities transactions. If creditors opt to exercise dominion so significant that it usurps the organization's normal ratification, management, and monitoring control functions, they should do so knowing that such intrusions will obligate them to act to prevent Securities Acts violations.³⁷³ If that were not the case, creditors could usurp the control of the corporation's authorized ratifiers, managers, and monitors without assuming their duties and consequently present the very situation Congress hoped to discourage with its enactment of sections 15 and 20(a).³⁷⁴

F. Collateral Professionals

(Attorneys, Accountants, Investment Bankers, and Others)

1. Control

Collateral professionals may play significant roles in the securities-related affairs of clients that violate the Securities Acts. For example, a company, its board of directors, and its executive officers will rely heavily on the advice and services of counsel in situations involving disclosure documents to be issued for examination by prospective investors.³⁷⁵ Moreover, such documents will bear the imprimatur of expert counsel that will signal compliance with applicable disclosure standards.³⁷⁶ This imprimatur facilitates acceptance of the offering and may give counsel leverage to seek maximum cooperation from management with respect to full disclosure. Generally speaking, then, counsel can be expected to wield influence in an enterprise's securities matters.

Independent accountants are likewise in a strategic position to influence management because without their cooperation, many securities transactions will not be feasible. Such a conclusion is justified when one considers the requirements of the Securities Acts with regard to certification of financial statements by independent account-

³⁷² See *supra* notes 176-80 and accompanying text.

³⁷³ See *supra* notes 176-80 and accompanying text.

³⁷⁴ See *supra* note 47 and accompanying text.

³⁷⁵ See Sonsini et al., *supra* note 170, at 370-71.

³⁷⁶ See generally Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

ants.³⁷⁷ Independent auditors have the responsibility for scrutinizing financial statements for material errors or irregularities.³⁷⁸ Auditors hold themselves out as independent professional sources of assurance that the audited company's financial presentations are accurate and reliable. The accountant's role, then, is so significant in the lives of enterprises involved in securities transactions that its potentially pivotal nature is unmistakable.

Investment bankers also may play a crucial role in an enterprise—especially a publicly held one—advising on and participating in a myriad of financial matters. For example, issuers typically rely on underwriters not only to verify issuer representations in prospectuses but also to acquire and process all available information to determine the price of the issue.³⁷⁹ Further, underwriters' due diligence is an important imprimatur that the issue meets industry quality standards.³⁸⁰ As a result of their strategic position and expertise, investment bankers generally are looked to for advice with regard not only to distributions

377 See RICHARD W. JENNINGS ET AL., CASES AND MATERIALS ON SECURITIES REGULATION 1173-74 (7th ed. 1992) ("The registration statement must contain certified financial statements, and the auditing firm which certifies them is subject to liability as an 'expert' with respect to those statements.").

378 See *id.*, stating:

The standard required of the firm in that capacity is that it "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Id. at 1174.

379 In *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), the court held that underwriters cannot take the statement of a company at face value. Rather, they have a broader duty:

[T]he phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel.

Id. at 697.

380 See *Investment Banker Liability: A Panel Discussion*, 16 DEL. J. CORP. L. 557, 564 (1991) (panel chaired by Arthur H. Rosenbloom) (explaining that, although not required, an investment banker's fairness opinion can help directors avoid liability).

but to a range of other financial transactions as well.³⁸¹ In light of these considerations, it seems clear that the role of investment bankers in the affairs of many enterprises will be significant.

Though collateral professionals frequently play a large role in the lives of their clients, they nonetheless should not fall within the ambit of "controlling persons" solely because of their provision of professional services, even when they consequently have substantial involvement in a securities transaction.³⁸² Ordinarily, collateral professionals are agents or independent contractors; persons retaining their services make the final decisions that may be implicated in Securities Acts violations.³⁸³ The impact of collateral professionals on a corporation's securities matters ordinarily will be one of influence rather than control.³⁸⁴ Moreover, subjecting collateral professionals to control-based potential liability for decisions they do not control would be counterproductive, since they would be deterred from participating in securities transactions or would participate only on a more costly basis.³⁸⁵

Furthermore, such legislative history as exists indicates that sections 15 and 20(a) were meant to impact corporate governance by subjecting those responsible for it to potential liability. They were designed to reach persons who control based on power (including authority), but seek to avoid the responsibility and liability for such control.³⁸⁶ Collateral professionals have not been identified as part of the *raison d'être* for the controlling person provisions. There is no record indicating that the role of collateral professionals was even discussed in connection with the enactment of sections 15 and 20(a).

381 See JENNINGS, *supra* note 377, at 88; Robert J. Guiffra Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 121-22 (1986) ("The heightened level of merger and acquisition activity over the past ten years has increased the role of investment bankers in corporate decision-making. Investment bankers identify acquisition candidates, provide tactical advice to bidder and target firms, negotiate transactions, and prepare valuations of companies involved in transactions."). See also Robert F. Greenhill, *Structuring an Offer*, 32 BUS. LAW. 1305, 1305-06 (1977).

382 *Barker v. Henderson*, Franklin, Starnes & Holt, 797 F.2d 490, 494 (7th Cir. 1986) ("[T]heir ability to persuade and give counsel is not the same thing as 'control,' which almost always means the practical ability to *direct* the actions of people who issue or sell securities.").

383 See *supra* note 24.

384 See *supra* notes 81-85 and accompanying text.

385 Cf. *Pinter v. Dahl*, 486 U.S. 622, 651 (1988) (observing that a low threshold for liability under section 12(1) would implicate securities professionals such as accountants and attorneys with only remote involvement in the transaction and might over-deter their involvement in activities related to lawful securities sales).

386 See *supra* Part II.

The Securities Acts did create a new regulatory framework to which collateral professionals had to respond in connection with their provision of services.³⁸⁷ However, the roles of collateral professionals in connection with securities distributions after the passage of the Securities Acts were essentially the same as before; they performed the same tasks before the passage of the Acts.³⁸⁸ Though Congress expressly addressed some concerns about professionals in the Securities Acts,³⁸⁹ there is no evidence that it thought provision of these services should render a professional a controlling person under sections 15 and 20(a).

It is true that collateral professionals may have some leverage in the sense they can act or threaten to act and by so doing cause management to change its course of conduct vis-à-vis a securities transaction.³⁹⁰ They can go to the highest channels in the enterprise or perhaps even to the SEC or the press with respect to alleged violations, and their threats to do so might prevent or end activity violative of the Securities Acts.³⁹¹ Indeed, a corporation's summer intern with a copy of a "smoking gun" document revealing securities fraud would

387 For example, section 11(4) of the Securities Act of 1933 allows for the potential liability for omissions or untrue statements of

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

15 U.S.C. § 77k(a) (4) (1994).

388 See Edward N. Gadsby, *Historical Development of the S.E.C.—The Government View*, 28 GEO. WASH. L. REV. 6, 8-9 (1959) (discussing the evolution of securities regulation and the effects of state blue sky laws).

389 See *supra* note 387 and accompanying text.

390 See *S.E.C. v. Nat'l Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978). In discussing the responsibilities of collateral professionals with regard to securities violations, Judge Parker wrote:

In view of the obvious materiality of the information, especially to attorneys learned in securities law, the attorneys' responsibilities to their corporate client required them to take steps . . . to speak out at the closing concerning the obvious materiality of the information and the concomitant requirement that the merger not be closed until the adjustments were disclosed and approval of the merger was again obtained from the Interstate shareholders.

Id. at 713.

391 Cf. *id.* It is important to note, however, that courts have been hesitant to impose a duty on attorneys to publicly disclose the Securities Acts violations of their clients. The Seventh Circuit, in *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d

have some control of the transaction in the sense that he could upset it by "blowing the whistle." However, he would not have control within the purview of sections 15 and 20(a). The intern will not have assumed or usurped an organizational governance role. There is no warrant for believing that the controlling persons provisions were meant to be gatekeeping or whistleblowing provisions.³⁹²

Where collateral professionals have another role or a stake in the enterprise, they may be deemed controlling persons on that basis. If, for example, collateral professionals own shares and act concertedly with other shareholders comprising a controlling block, they may be grouped with those shareholders and thus be within the purview of sections 15 and 20(a).³⁹³ Likewise, when collateral professionals assume directorial or executive positions or functions, they may be sub-

490 (7th Cir. 1986), rejected a plaintiff's assertion that damages should be awarded against a law firm that failed to "tattle" on its clients' securities law violations:

We express no opinion on whether the Firms did what they should, whether there was malpractice under state law, or whether the rules of ethics (or other fiduciary doctrines) ought to require lawyers and accountants to blow the whistle in equivalent circumstances. We are satisfied, however, that an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal and accounting professions. Liability depends on an *existing* duty to disclose. The securities law therefore must lag behind changes in ethical and fiduciary standards. The plaintiffs have not pointed to any rule imposing on either Firm a duty to blow the whistle.

Id. at 497. For further discussions of the professional responsibility of lawyers and their duties to clients in securities-related matters, see Committee on Federal Regulation of Securities (Section of Corporation, Banking and Business Law) & Committee on Securities Transactions (Section of Litigation), *The Evolving Problems for and Responsibilities of Attorneys Under the Federal Securities Laws* (Symposium), 36 BUS. LAW. 1777 (1981) (discussing whether corporations and individual employees of that corporation should have separate or common legal representation); Samuel H. Gruenbaum, *Clients' Frauds and Their Lawyers' Obligations: A Response to Professor Kramer*, 68 GEO. L.J. 191, 192 (1979) (arguing that an attorney's duty to disclose his client's fraud should not be solely analyzed from the perspective of professional responsibility; rather, such a duty should also be examined in the context of the responsibility imposed by the SEC and the attorney's potential exposure to civil or criminal liability); Michel Rosenfeld, *Between Rights and Consequences: A Philosophical Inquiry into the Foundations of Legal Ethics in the Changing World of Securities Regulation*, 49 GEO. WASH. L. REV. 462 (1981) (discussing whether the ethical obligation of the securities attorney is to secure the rights of his client or to assist in the enforcement of securities laws by divulging his client's confidences).

392 See Kraakman, *supra* note 376.

393 Cf. WILLIAM H. PAINTER, BUSINESS PLANNING 561 (3d ed. 1994).

ject to sections 15 and 20(a) as controlling persons, in light of their authority to control or actual control.³⁹⁴

2. Liability

If collateral professionals are deemed to be controlling persons, for reasons other than the mere provision of professional services, they should be liable, as any other controlling person, unless they establish their statutory defenses. Hence, for example, a person serving simultaneously as both a director of an enterprise, as well as outside legal counsel of the enterprise, should have his defense to liability approached as a director—the basis of his controlling person status. Their professional status, however, should be factored into the liability calculus of any controlling person. In connection with the analysis of the adequacy of their defenses, the specialized knowledge and sophistication of collateral professionals should bear on their culpability and liability, in appropriate circumstances.³⁹⁵ Moreover, controlling persons who also are collateral professionals may be exposed to information in connection with their provision of professional services, and such exposure may make it more difficult for them to convince the tribunal that they lacked knowledge of the Securities Acts violations of their controlled person.³⁹⁶

VII. CONCLUSION

My goal has been to identify the congressional intent underlying the controlling persons provisions and to suggest approaches to the provisions likely to result in the imposition of liability consistent with that intent. If “distance” from primary violators is not to provide a

394 See *id.*

395 See *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 577 (E.D.N.Y. 1971) (“What constitutes ‘reasonable investigation’ and a ‘reasonable ground to believe’ will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data.”); *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 686 (S.D.N.Y. 1968) (declaring that an executive committee member, a lawyer, should have known that his obligations under the statute included a requirement to make a reasonable investigation of the truth of the statements in certain portions of the registration statement he signed); Comment, *BarChris: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1416 (1968) (“It was clear from the outset, however, that the duty of each potentially liable group was not the same. The House report on the bill that became the original Securities Act stated that the duty of care to discover varied in its demands upon the participants with the importance of their place in the scheme of distribution and the degree of protection that the public had a right to expect from them.”).

396 *Feit*, 332 F. Supp. at 575-76.

rather automatically prevailing defense for controlling persons, sections 15 and 20(a) must be interpreted in a manner designed to encourage reasonable diligence on their part. Otherwise, controlling persons need only interpose other persons between themselves and situations rife for Securities Acts violations to avoid liability. This is precisely the kind of situation Congress hoped to discourage when it enacted the controlling persons provisions. There are two major kinds of control relevant for analysis of sections 15 and 20(a): control by authority and actual control. Those with authority to control can be identified more easily since the authority-generating status or position will give the occupier a prominent profile within the context of the subject organizational framework. It is appropriate to presume their controlling person status, since they have voluntarily accepted positions with the potential for, and frequently the responsibility for, control. On the other hand, plaintiffs should be required to support a claim of actual control by making a showing of a significant base (or bases) of power. The somewhat inclusive approach to the question of controlling person status advocated herein is not inconsistent with the statutory language and, importantly, serves to place at least some burden on significant actors in an organizational framework consistent with congressional design. It is likely that for some controlling persons this burden will be modest indeed and perhaps appropriately so, especially when there is no exercise of the actual control.

With regard to liability, the question should be approached differently depending upon whether the defendant controls on the basis of authority or on the basis of actual control. Those with legal control have affirmative duties that obligate them to act. Those with actual control have no duties merely because they have power. It is only where there is a significant exercise of their actual power that those possessing actual control, but not authority to control, should be obligated to manage or monitor their controlled person nonnegligently (section 15) or nonrecklessly (section 20(a)) for Securities Acts violations to avoid liability. What is needed in the context of the Securities Acts, and what may be achieved through a proper application of sections 15 and 20(a), are meaningful standards of conduct for controlling persons—standards that approximate legitimate fiduciary ones. This is precisely what Congress hoped to achieve with its enactment of sections 15 and 20(a).